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Part V

Council on Wage and Price Stability

Modification of Voluntary Price Standards; Request for Comments

COUNCIL ON WAGE AND PRICE STABILITY

6 CFR Part 705

Request for Comments on Modifications of Voluntary Price Standards

AGENCY: Council on Wage and Price Stability.

ACTION: Request for comments on modifications of voluntary price standards.

SUMMARY: The Council is seeking broad public participation in evaluating the voluntary price standards program. Public input analyzing and reviewing the second program year is essential for designing an effective third-year program.

To facilitate preparation of comments, the Council has provided background information on issues that must be resolved for the third program year. These practical and conceptual issues raise a number of possible modifications of the standards.

Assuming that there will be a third program year, the Council intends to publish interim final price standards in September 1980.

DATES: Written comments on modifications of voluntary price standards should be submitted by August 1, 1980.

ADDRESS: Send comments to: Office of General Counsel, Council on Wage and Price Stability, Winder Building, 600 17th Street, N.W., Washington, D.C. 20506.

FOR FURTHER INFORMATION CONTACT: Patrick Macfarland (202) 456–6286.

SUPPLEMENTARY INFORMATION: The Council is specifically soliciting comments on the issues presented in this document, although comments on any related issues will be appreciated. Comments should be sent to the above address no later than August 1, 1980.

Authority: Council on Wage and Price Stability Act, Pub. L. 93–387, as amended (12 U.S.C. 1904, note); E.O. 12092 (November 1, 1978); E.O. 12161 (September 28, 1979).

Issued in Washington, D.C. July 7, 1980.

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THE PAY/PRICE STANDARDS PROGRAM; EVALUATION AND THIRD-YEAR ISSUES

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I. Introduction

The purpose of this document is to solicit public comment on one of the central components of the broad anti-inflation program that the President announced in October 1978—the voluntary pay and price standards. During the first year of the program, the standards restrained the rise in prices and employment costs in the industrial sector of the economy. But accelerating inflation created problems for designing the second-year program, and we observed at that time that some of the provisions of the standards created distortions or inequities. To initiate the process of evaluation and review and to encourage public participation, we published an *Issue Paper* on August 7, 1979, requesting comments on the first-year standards. The paper included an economic review of the first program year as well as a discussion of conceptual and practical issues on which we particularly wanted the public to focus.

The response to the *Issue Paper* was helpful in developing the second-year standards—not only in revealing how the public perceived the program but also in getting the public's views on some of the options for resolving the technical issues. After considering the responses to the *Issue Paper,* the Council on September 28, 1979, published interim final second-year price standards. With minor changes, these standards became final on November 1, 1979.

As a result of comments that this program, unlike previous ones, had not included a clearly defined role for representatives of labor, management, and the public, the President created the Council's Pay Advisory Committee. The Committee, composed of 18 members—six representatives each from labor, business, and the general public—was given a variety of tasks, with its principal assignment being to recommend modifications of the pay standard, including the basic pay limitation, the inflation assumption for evaluating cost-of-living-adjustment clauses, and the adjustment for employee units not covered by such clauses. The Council's Price Advisory Committee was also created to include six representatives of the general public and it was asked to comment on the revised price standard developed for the second program year.

As we approach the end of the second program year, we confront the question, once again, of whether the pay and price standards should be extended for a third year, and, if so, with what changes, major or minor. Historically, programs like this tend to diminish in effectiveness over time and may develop distortions and inefficiencies. Against these considerations, we must weigh the manifest need for continued pay and price restraint, and the doubt that restrained monetary and fiscal policy alone can limit inflation except at excessive costs.

Because the comments we received last year were helpful and because many interested parties have asked for one, we have published another *Issue Paper.* Like last year's, it includes an evaluation of the standards program to

date, drawing on both published aggregate data and aggregated company-specific data supplied to the Council (although the latter are available so far only for the first program year). This evaluation (presented in Section II) constitutes a regulatory review of the standards program. Section III attempts to identify both fundamental issues—including the most fundamental one of whether the standards should be continued in something like their present form—and technical issues on which we wish to have the public's comments.

The situation with the pay standard differs from that with the price standards. The Council adopted the present pay standard only recently after lengthy consideration by and consultation with the Pay Advisory Committee. We have therefore decided that it would be premature to publish a discussion of pay-standard issues at this time, although comment on this subject is not precluded.

II. Evaluation of the Program

Our evaluation begins with a review of wage and price developments both before and during the program (Subsection A). This cursory review provides evidence about the program's effectiveness—based upon both what actually happened during the program and estimates of what would have happened in the absence of the program. Subsections B and C use aggregated company data supplied to the Council to assess the extent to which companies were constrained by the standards and to quantify the amount of noncompliance with the standards and the various sources of slippage (i.e., variation from the basic pay and price limitations attributable to exemptions, exceptions, and exclusions).

A. Analysis of Aggregate Wage and Price Data

1. *Price Performance.* When the anti-inflation program was announced in October 1978, the annual rate of inflation—as measured by the Consumer Price Index (CPI)—was running about 9 percent (see Table 1). During the first quarter of the program, the inflation rate changed very little, but in early 1979 it escalated sharply to about 13 percent. Then, after remaining in the 13-to-14-percent range throughout 1979, it rose sharply again in early 1980 reaching an annual rate of 18 percent, before falling in April and May to an annual rate of 11 percent.

Table 1.—*Selected Components of the Consumer Price Index*

[Seasonally adjusted, annual percentage rates of change]

	December 1979 relative importance (percent)	Calendar 1978 [1]	Calendar 1979 [1]	First program year					Second program year		
				Change over previous quarter							
				78:III	78:IV	79:I	79:II	79:III	79:IV	80:I	March to May [2]
All Items	(100.0)	9.0	13.3	8.9	8.9	13.0	12.8	13.8	13.7	18.1	11.3
Energy Commodities	(6.9)	8.1	52.3	10.9	18.9	37.5	83.8	67.9	26.7	96.5	0.0
Mortgage Interest Cost (MIC)	(8.7)	22.0	34.7	24.0	25.1	31.5	27.7	29.0	52.8	53.8	47.3
Food	(17.7)	11.8	10.2	6.7	11.6	16.0	6.4	6.5	12.1	3.8	5.2
All Items less MIC and Energy Commodities	(84.4)	8.4	9.2	7.7	7.2	10.2	8.0	9.3	9.5	9.8	8.8
All Items less Food, MIC, and Energy Commodities	(66.8)	7.3	9.0	7.9	6.9	8.7	8.4	10.0	8.9	11.4	9.8
Underlying Rate [3]	(47.9)	6.5	7.8	6.6	7.2	7.5	7.2	8.1	8.6	12.7	9.7

[1] December-to-December changes not seasonally adjusted.
[2] Rates of change from March to May; June figures are not yet available.
[3] The Consumer Price Index excluding the costs of food, energy, used cars, and home purchase, finance, insurance, and taxes.
Source: CWPS calculations based on data from U.S Department of Labor, Bureau of Labor Statistics.

These accelerations are commonly cited as evidence that the pay/price-standards program was ineffective. That summary conclusion is not well founded. The standards program necessarily excludes many prices from its coverage; it makes no sense to apply standards that call for price restraint in markets where sellers have little or no discretion in setting prices—i.e., in highly competitive markets, where attempts to hold prices below market-clearing levels would quickly generate damaging shortages. We therefore excluded from the program prices set in organized exchange markets. We also excluded raw-material prices, generally, because most are determined in highly competitive world markets, and attempts to restrict these prices artificially could quickly reduce domestic supplies. Also excluded are prices set by sales contracts in effect before the program, prices of new or custom products (since it is impossible to compute price changes for these commodities), and interest rates (since these are competitively determined and are heavily influenced by policy decisions of the Federal Reserve Board). Despite these exclusions, about 60 percent of the economy is covered by the price standards, as compared to about 45 percent under the Nixon Administration's mandatory controls.

The surge in the inflation rate in 1979 and early 1980 was the result primarily of a sharp acceleration in prices not covered by the standards. The world-wide economic expansion that continued throughout 1979 sent raw-material prices skyrocketing. These soaring, raw-material prices rippled through the American economy, forcing many companies off the basic price limitation and onto the gross-margin and profit-margin limitations, which allow uncontrollable cost increases to be passed through.

The most dramatic raw-material price surge was the 110-percent increase in crude-oil prices during 1979 and early 1980. This jump contributed to the 80-percent increase in the U.S. energy-commodity prices during that period. In fact, the energy-commodity component of the CPI, accounting for only 7 percent of the weight, was directly responsible for one-fifth of the overall increase in consumer prices in 1979, and nearly one-third of the price surge in the first quarter of 1980.

There were, moreover, substantial *indirect* effects, not only because energy is an important input into the production process, but also because rising consumer prices elicit higher wage demands, and so inflate labor costs. It has been estimated that the total effect of energy-price increases is roughly double the direct effect, although much of the indirect effect is lagged. We independently estimate that at least 2 percentage points of the inflation rate in early 1980—on top of the 5.2 points of direct impact—is attributable to the

lagged effect of soaring energy prices in 1979.

Of course, not all of this increase in energy prices can be attributed to the doubling of crude-oil prices during this period; a large part is attributable to the substantially expanded margins of both petroleum refiners and gasoline and home-heating-oil retailers and distributors. Earlier this year, the Council published a detailed analysis of these expanded margins (*Petroleum Prices and the Price Standards,* February 25, 1980).

Another important contributor to the recent surge in the CPI was the steep climb in interest rates. This contributes directly to the measured rate of inflation through the homeownership component of the CPI. Mortgage interest costs increased 35 percent during 1979, and at an annual rate of 54 percent in early 1980. Thus, the mortgage-interest component of the CPI, whose weight is only 8⅛ percent of the total, was responsible for one fourth of the total inflation in 1979 and the first quarter of 1980.

Taken together, energy-commodity prices and mortgage-interest costs, which accounted for less than one-sixth of the weight of the CPI, were responsible for nearly half of the inflation in 1979 and for over half of the inflation in the first quarter of 1980. Even more dramatic, they accounted for three-fourths of the *acceleration* in inflation from 1978 to 1979 and from 1979 to the first quarter of 1980.

No reasonable anti-inflation program could have prevented the surge of inflation caused by the escalation of crude-oil prices and interest rates. No petroleum importing country has insulated itself from the world-wide explosion of crude-oil prices. The U.S. economy has, indeed, been the hardest hit, because it is the most energy-intensive country in the world other than Canada (see section V of the Council's *Inflation Update,* released June 12, 1980). Similarly, any attempt by the Federal Reserve Board to prevent the surge in interest rates by accomodating the large demand for credit would have exacerbated the inflation by expanding the money supply even more rapidly and adding to aggregate demand. The degree to which interest rates can be lowered by expanding the money supply is limited since high interest rates are as much a result as a cause of high inflation rates. (The inflation rate affects interest rates by influencing price expectations and hence the expected real rates of return from any given level of interest rates.)

For these reasons, both crude-oil prices and interest rates have been excluded from the program, and the very large part of inflation for which they have been responsible cannot be attributed to noncompliance with the standards. On the other hand, this experience demonstrates the limitations of wage and price standards as an instrument for combating inflation: They are essentially powerless to prevent inflation caused by either excess aggregate demand or surging raw-material prices.

The proper measure to be used in assessing the program's effectiveness is the behavior of prices in the sector of the economy that it covers. No precise index is available. As a proxy, we have used the CPI-based underlying inflation rate (the CPI less the food, energy, homeownership, and used-car components). This and other underlying-rate concepts which are intended to measure fundamental inflationary pressures in the industrial and service core of the economy (in contrast with the effects of exogenous shocks such as the crude-oil price increase) are discussed in the Coucil's latest *Inflation Update* (June 12, 1980).

The CPI-based measure of the underlying rate of inflation was 6½ percent when the program was announced in October, 1978. It accelerated very little until the third quarter of 1979, when it moved up to 8 percent. Another gradual increase, to about 8½ percent, in the fourth quarter of 1979 was succeeded by an abrupt ascent to about 12½ percent in the first quarter of 1980. The rise in the underlying inflation rate reflected in this measure was genuine; on the other hand, the 12½ percent figure exaggerates it, since it reflects, in large part, the temporary surge of energy costs through other sectors of the economy; a surge that would be expected to abate, with a lag, once the surge of energy prices themselves abated.

Like the changes in the entire CPI, accelerations or decelerations of even the underlying inflation rate do not in themselves provide clear evidence of the effectiveness or ineffectiveness of the program. The ideal test, of course, is a comparison of the actual inflation rate with the rate that would have prevailed in the absence of the program; we will report some results of such comparisons in the final segment of this section. Another approach is to compare the price increases that actually took place with what the standards would have allowed; this we will do here.

The underlying inflation rate during the 1976–77 based period—as measured by the CPI residual—was about 6–1/4 percent. Because the first-year price standard called for price increases 1/2 percentage point below those in the base period, one would expect, with universal compliance and no slippage (i.e., in the absence of larger price increases attributable to exceptions and exclusions from the general standard), an underlying rate of inflation during the first year of 5–3/4 percent. The actual rate was 7–1/2 percent, suggesting slippage and/or noncompliance of about 1–3/4 percentage points. As will be seen in the next section, most of the slippage is attributable to the passing through of the surge in raw-material prices throughout 1979 under the exceptions and alternative standards available to those with uncontrollable cost increases.

In the second year, the price standard was loosened by 1 percentage point. Hence—again with universal compliance and no slippage—one would expect the underlying rate of inflation to have been about 6–3/4 percent. The actual annual rate during the first quarter of the second program year was 8–1/2 percent, indicating slippage of about 1–3/4 percentage points—the same as in the first program year. The apparent slippage increased substantially in the first quarter of 1980, but appears to have declined since then.

To conclude, inflation rates in the sectors covered by the standards appear not to have been inexplicably larger than would be expected with universal compliance and no slippage. Because there was substantial slippage attributable to the surge in raw-material prices, the aggregate price data do not support the contention that the standards were ineffective.

2. *Wage Performance.* The pattern of changes of wages and other measures of labor compensation suggest that the pay standard has had a definite restraining influence. Wage inflation during the first year of the program was slightly below the rate in the preceding year, despite the sharp acceleration that took place in the cost of living and concomitant decline in real wages (see Table 2). Union wages went up by 8–1/2 percent, and nonunion wages by 7–1/2 percent. The average increase in total private labor compensation (wages plus private fringe benefits) was about 1/2 percentage point higher than in wages alone, because fringe benefits increased by 12 percent.

The 8–1/2 percent increase in total private labor compensation during the first year of the program was about 1–1/2 percentage points above the 7-percent pay standard. It thus appears that the amount of slippage on the pay side was slightly smaller than on the price side—a result that is not surprising in view of

the substantial increase in raw-material prices during that year.

Wage inflation appears to have accelerated somewhat in late 1979 and early 1980. The rate of increase of the hourly earnings index moved up to 9–1/2 percent in the second half of 1979 and to 10 percent in the first quarter of 1980.

Table 2.—*Selected Measures of Employee Compensation (Private Nonfarm Sector)*[1]

[Seasonally adjusted, annual percentage rates of change]

	Fiscal 1978	Fiscal 1979	First program year					Second program year		
			Change over previous year							
			78:III	78:IV	79:I	79:II	79:III	79:IV	80:I	March to May
Average Hourly Earnings	8.6	8.3	8.0	10.0	8.4	6.1	8.8	8.6	9.1	3.7
Hourly Earnings Index	8.4	8.2	8.0	8.4	7.9	7.0	9.6	9.2	10.0	6.5
Employment Cost Index	8.0	7.7	8.2	6.1	8.2	7.8	8.7	10.0	10.0	.....
Union	7.9	8.4	8.7	8.2	7.4	8.7	9.1	10.8	9.5	.....
Nonunion	8.0	7.3	7.8	4.5	8.7	7.8	7.8	9.5	10.4	.....
Total Hourly Compensation	8.6	8.9	8.7	8.7	10.3	7.9	8.6	9.0	10.3	.....
Private Hourly Compensation	8.4	8.8	9.0	8.8	8.8	8.2	8.9	9.1	10.2	.....
Wages & Salaries Per Hour	8.2	8.3	8.6	8.5	8.8	7.4	8.1	8.7	9.7	.....
Fringe Benefits Per Hour	10.1	12.0	12.3	9.1	8.9	15.2	15.2	12.6	13.7	.....
Employer Contributions to Social Insurance Per Hour	11.7	12.2	5.0	7.4	33.5	5.2	5.2	6.6	13.3	.....
Real Hourly Earnings Index	0.1	−3.6	−0.3	−0.4	−5.3	−5.7	−3.4	−4.1	−7.1	−4.6
Real Spendable Earnings (Weekly)	−3.2	−3.9	−2.4	−0.4	−1.3	−9.5	−4.4	−5.6	−11.8	−11.4

[1] Fiscal year figures for the Employment Cost Index and all hourly and real-earnings series are September-to-September changes and quarterly figures measure three-month changes. Hourly compensation, productivity, and unit labor costs are for all employees in the nonfarm business sector, fiscal year figures measure third quarter to third quarter changes.

Source: CWPS calculations based on data from U.S. Department of Labor, Bureau of Labor Statistics; and U.S. Department of Commerce, Bureau of Economic Analysis.

An interim pay standard was in effect during the last quarter of 1979 and the first quarter of 1980 while the Administration awaited the recommendations of the Pay Advisory Committee. During this period, the Council implemented an automatic 1-percentage-point catch-up adjustment for workers in employee units that were in compliance during the first program year and did not have cost-of-living-adjustment clauses, which raised the standard to 8 percent for the great majority of workers. The 9-to-10 percent increases that actually occurred in this period thus reflect a difference of about 1 to 2 percentage points, which is comparable to the different in the first program year.

3. *Wage Distributions.* The behavior of average wage increases provides some indication of wage restraint under the program. The intent of the standards, however, is not to restrain all wage increases, but rather to discourage increases in excess of the stipulated ceiling after allowances for exceptions and exclusions, without elevating increases that otherwise would have been below it. We can roughly assess our success in achieving these goals by examining the way in which individual wage increases were distributed.

Figure 1 shows distributions in the first program year (1978:IV to 1979:III) and the base period (1977:IV to 1978:III). (For simplicity, we refer to the former of these periods as 1979 and the latter as 1978). The data are nominal wage increases for all workers.

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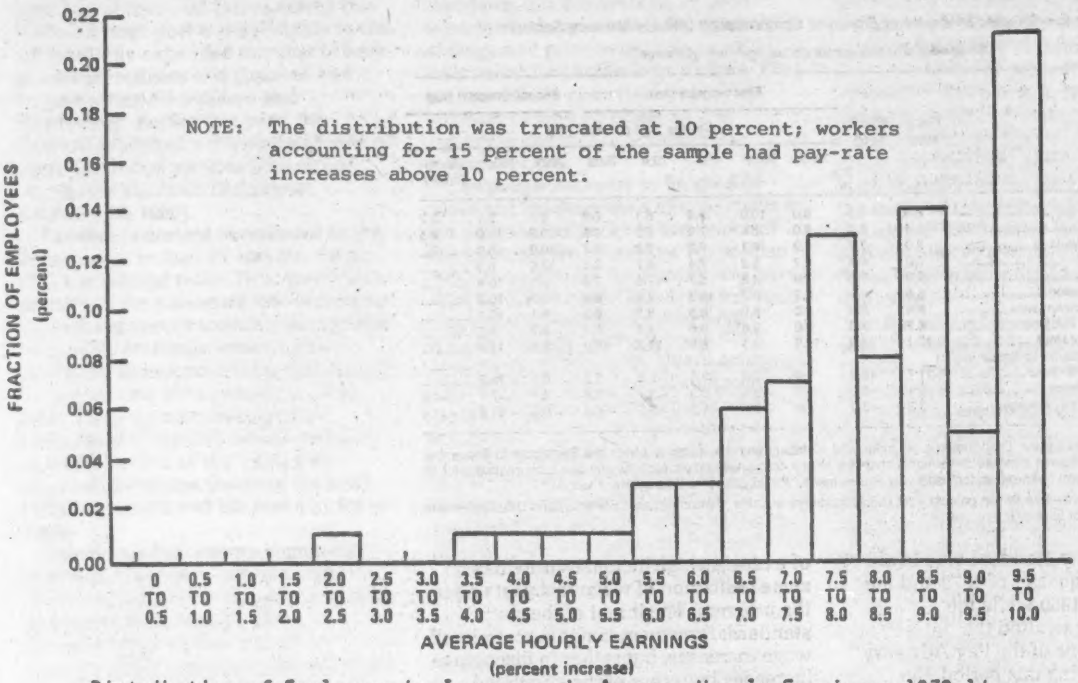
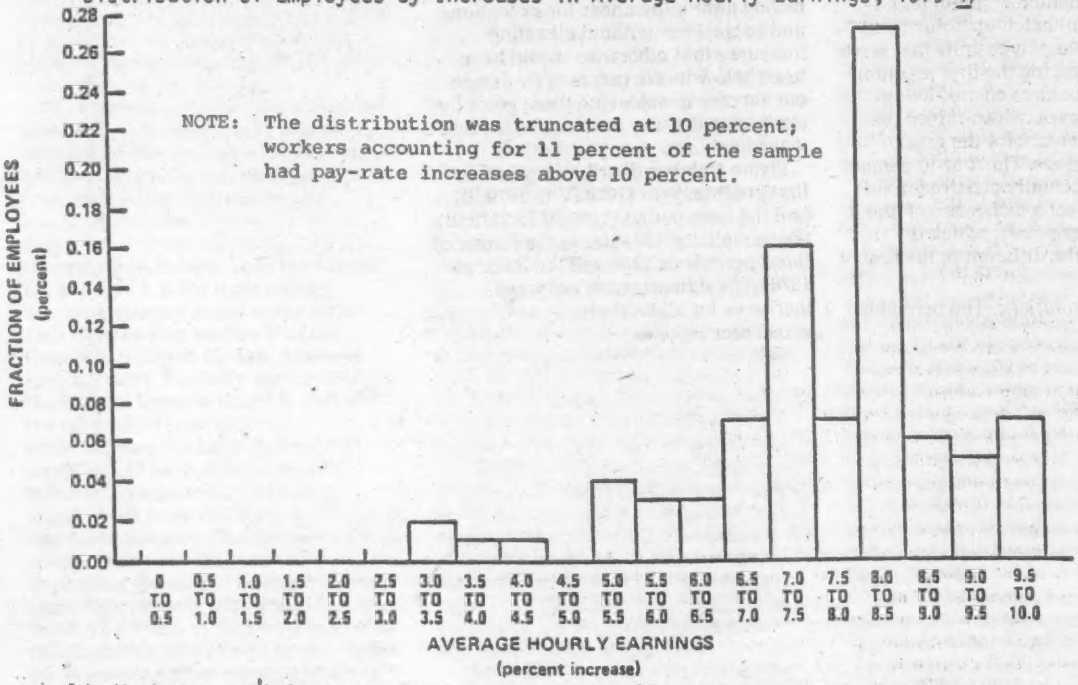
Figure 1

Distribution of Employees by Increases in Average Hourly Earnings, 1978 1/



Distribution of Employees by Increases in Average Hourly Earnings, 1979 1/



1/ Workers receiving pay-rate increases above 10 percent are not shown.

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It is clear from these distributions that the bulk of the increases was redistributed from the 8½-to-10-percent to the 7-to-9-percent range between 1978 and 1979. Moreover, there is no evidence of an upward shift of the concentration of workers at the lower end of the distribution—i.e., no evidence of a tendency for the ceiling to become also a floor. As a result, the average (mean) pay increase was lowered from 8½ percent to 8 percent. The downward shift in the distribution between 1978 and 1979 would be even more pronounced if we were to show real rather than nominal wages, because the rate of increase in the CPI rose from 8.3 percent to 12.1 percent in this same interval.

To summarize, despite the substantial inflationary pressures on wages during the first program year, there was a downward shift in the upper range of wage increases and no upward shift in the lower part of the range. The fact that a substantial number of workers received increases just above 7 percent is largely the consequence of the various exceptions and exclusions incorporated into the standard to avoid inequities and market distortions. We examine these adjustments in detail in Section II–B, which also contains an analysis of wage distributions drawn from the data supplied by individual companies.

4. *Simulation Results.* The previous sections provide impressionistic evidence that the standards program was reasonably effective in preventing the spillover of the energy-price surge into the industrial wage/price structure. The relatively modest escalation in wage inflation and in the underlying inflation rate (compared to the much greater escalation of the overall inflation rate) supports the view that the standards had some effect in restraining wage and price increases.

In order to assess rigorously the effectiveness of a program whose purpose is to alter the course of events, it is necessary to estimate (as best one can) what would have happened in its absence. Obviously it is not possible to perform an experiment over the life of the program that would compare what would have happened both with and without it. It is possible, however, to construct models that predict the behavior over time of the relevant variables and to use such models to simulate what would have happened to these variables in the absence of the program (and of any other structural changes that may have occurred in the wage/price process that could have caused the results to differ from what would have been predicted from historical experience). A comparison of the simulated results with what actually happened allows one to assess the effect of the program, assuming that the advent of the standards was the principal structural change in that process.

Because of numerous statistical problems, constructing wage/price models that generate reliable simulations over the program period is difficult. Some preliminary work on this problem has been done by the Council of Economic Advisors (see the *Economic Report of the President,* January 1980) and by the Council (see our *Interim Report on the Effectiveness of the Pay and Price Standards,* May 6, 1980).

Using a variety of models developed by others as well as its staff, the CEA estimates that the annual rate of growth of wages during the first program year would have been 1 to 1½ percentage points greater were it not for the standards. Our simulation exercises suggest that the annual rate of growth of average hourly earnings was 1.8 to 2.0 percentage points less than it would have been without the program. We also estimate that the CPI-based underlying rate of inflation (the CPI less the costs of food, energy, used cars, and home purchase, finance, taxes, and insurance) would have been 1.1 to 1.5 percentage points higher; hence, the overall inflation rate—assuming that the program had *no* effect on the costs of food, energy, used cars, and home purchase, finance, taxes, and insurance—would have been one-half to three-quarters of a percentage point higher.

These simulation results suggest that the program had a greater restraining effect on wages than on prices. There are two major reasons for this difference. First, the price standards could not and should not have constrained the prices of primary energy goods, houses, interest rates, and food at the farm; hence, the effect of the price standard on the covered sector is diluted when it is evaluated on the basis of its effect on the entire Consumer Price Index. Second, even within the covered sector, there was more slippage on the price than the wage side, primarily because of the unavoidable passthroughs of energy and other raw-material costs.

It would, therefore, be incorrect to conclude from these simple comparisons that the standards bore discriminately unfairly on wages. In fact, labor's share of total income was not compressed relative to the profit share. Since the program was announced, the profit share has *decreased* from 10.0 percent to 8.6 percent, while labor's share has *increased* from 75.4 percent to 76.4 percent. Almost half of the increase in labor's share, however, is attributable to rising social insurance taxes; the share of wages and salaries plus private fringe benefits increased by only 0.5 percentage points—from 65.9 percent in 1978:III to 66.4 percent in 1980:I (see Table 3). More important, simulation studies carried out by the Council in its *Inflation Update* (June 12, 1980) suggest that the observed changes in income shares during the program period are explained largely by business cycle variables—i.e., that the program had no (statistically significant) effect on income shares. This is not surprising, as the program was designed to be neutral with respect to income shares.

Table 3.—*National Income Shares During the Program Period*

[Percent]

	Corporate profits [1]	Interest income	Rental income [2]	Proprietors income [1]	Labor compensation		
					Total labor compensation	Social insurance taxes	Wages, salaries, and private fringe benefits [3]
1978:III	10.0	6.4	1.5	6.7	75.4	9.5	65.9
1978:IV	10.2	6.5	1.5	6.9	75.0	9.4	65.6
1979:I	9.6	6.6	1.5	6.9	75.5	9.9	65.6
1979:II	9.3	6.6	1.4	6.8	75.9	9.9	66.0
1979:III	9.3	6.8	1.4	6.7	75.9	9.8	66.1
1979:IV	8.9	7.0	1.4	6.8	76.0	9.8	66.2
1980:I	8.6	7.3	1.3	6.4	76.4	10.0	66.4

[1] Before taxes with inventory valuation adjustment and capital consumption adjustment.

[2] With capital consumption adjustment.

[3] Fringe benefits include employer payments for private pension, health and welfare funds, compensation for injuries, directors' fees, and pay of the military reserves.

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

B. Analysis of Company-Specific Pay Data

As part of its monitoring effort, the Council collected data on pay-rate increases granted during the first program year by compliance units with 10,000 or more employees. These data shed additional light on the effects of the program on wages.

The pay standard requires companies to partition workers into three categories: those employees subject to a collective-bargaining agreement, all management employees, and all other (nonmanagement nonunion) employees. Hence, separate statistics are available for these three groups. In all, the pay reports cover 7½ million workers—close to a third of them in management units, about a fifth in collective-bargaining units, and the rest in the all-other category. The reports do not cover workers excluded under the low-wage exemption (those with straight-time hourly wages of $4.00 or less on October 1, 1978) or collective-bargaining units whose contracts were not renegotiated during the first program year. By subtracting these excluded groups from the total work force, we estimate that the number of workers covered by the pay standard in the first year was 48 million; thus, the pay-reporting forms encompass about 15½ percent of the covered work force.

The average increase in wages plus fringe benefits (before adjustments for exclusions and exceptions) for workers in the reporting universe was 7.6 percent in the first year of the program—11.0 percent for union workers and 6.6 percent for both the management and nonmanagement nonunion groups combined. (See Table 4.) The discrepancy between this 7.6 percent and the 8.6-percent increase in private hourly compensation, in fiscal-year 1979 for the entire economy (see subsection A) is attributable to several factors.

First, the applicable periods for the data reported in Table 4 do not conform precisely to the Council's first program year (essentially fiscal-year 1979). For example, the first year of a collective-bargaining agreement signed late in the first program year would extend well into the second program year.

Second, many of the collective-bargaining contracts contain cost-of-living adjustment (COLA) clauses, and the cost of these, as reported to us, are based on company assumptions about the prospective inflation rate. Other data supplied by these companies indicate that they assumed, on average, an inflation rate of about 9.4 percent—substantially below the 13.5 percent that the CPI actually increased, on average, during the first year of collective-bargaining agreements signed during the first year of the program (estimated roughly as the average of the CPI increases over the nine annual periods, September 1978 to September 1979, October 1978 to October 1979, and so on up through May 1979 to May 1980). With an assumption of an average recovery rate of 60 percent (i.e., that a one-percentage-point increase in the CPI results in an average COLA-payment of 0.6 percentage point), this average under-forecast of the CPI increase resulted in a 2½ percentage-point underestimation of COLA payments. Because approximately 3 percent of the workforce signed collective-bargaining agreements with such clauses during the first program year, this undervaluation accounts for about 0.1 percentage point of the one point difference between the reported increase and the national aggregate increase.

Another factor explaining this disparity is the exclusion from the reporting sample of the increases under collective-bargaining agreements signed before the announcement of the program. We estimate that these averaged 8.1 percent and that the affected workers account for about 14½ percent of the total workforce. Thus, the exclusion of these workers from the reporting universe accounts for another 0.1 percentage point of the 1.0 point disparity.

Finally, the low-wage exemption accounts for a substantial share of the disparity. Approximately 35 percent of the workforce was excluded under this exemption. We estimate that, on average, these excluded workers received 9½-percent increases during the first program year (the increase in the minimum wage was 9.4 percent, and workers slightly above the minimum wage received comparable increases in order to avoid wage compression). After appropriate weighting of these percentage increases by the low level of wages involved, we estimate that the low-wage exemption accounts for about 0.4 percentage point of the one-point difference.

The three quantified factors—underestimation of the costs of COLA clauses, exemption of increases under pre-existing contracts, and the low-wage exemption—account for about six-tenths of the 1.0-percentage-point disparity between the increase in the national aggregate wage level and the increases shown by our reporting universe. The small remainder can be attributed to statistical error and the possible differences between the wage increases of reporting and nonreporting compliance units (for example, most of the workers covered by construction and teamsters settlements—which typically provided for very large increases—are in compliance units with less than 10,000 workers).

As noted above, the average reported first-year increase under collective-bargaining agreements was 11.0 percent. The average annual increase over the lives of the contracts was 8.9 percent. The first-year pay standard restricted the increase in each year of a multi-year contract to no more than 8 percent and the average annual increase to no more than 7 percent. The fact that the reported increases are above the respective limitations does not necessarily mean that these increases

Table 4.—*Pay Data for Reporting Units* [1]

	All workers [2]		Collectivebargaining units [2]		Management units	All other units
Number of workers	7,430,162		1,399,054		2,415,395	3,615,713
Percent of workers	100.0		18.8		32.5	48.7
	First year	Annual average over life of contract	First year	Annual average over life of contract		
Unadjusted percentage pay-rate increase	7.6	7.1	11.0	8.9	6.6	6.6
Adjusted percentage pay-rate increase	6.3	6.1	7.9	6.8	5.8	5.8
Adjustment	1.3	1.0	3.1	2.1	0.8	0.8

[1] The percentage increases are obtained by averaging across employee units, using base-period employment as weights.
[2] Pay increases for collective-bargaining units are calculated in two ways: The first-year calculations represent the costs of the first year of collective-bargaining agreements negotiated during the program period, while the annual-average data pertain to the (geometric) average annual rate of increase over the life of the contract. Because of front-loading, the first-year estimates for multi-year contracts are usually larger than the annual averages.

were not in compliance with the pay standard. For the purpose of evaluating compliance, the pay standard provided for several departures from actual costs. The most important of these adjustments is attributable to the CPI assumption used in evaluating COLA's. The 6-percent inflation-rate assumption stipulated by the standards turned out to be below the actual inflation rate and below the assumptions made throughout the year by employers. In addition, the standard provided a number of exceptions and exclusions, in order to assure that it does not generate unnecessary inequities or inefficiencies.

Adjustments such as these lowered the average pay-rate increases of all three categories of employees, as measured under the standard; but the adjustment was especially dramatic in the case of collective-bargaining units. The average downward adjustment for union workers was 3.1 percentage points for the first year and 2.1 percentage points for the annual average over the lives of the contracts. In contrast, the average adjustment for both management and nonmanagement nonunion units was 0.8 percentage points. Thus, the average chargeable first-year increase for union workers was 7.9 percent (slightly below the 8-percent limit), and the average annual chargeable increase over the lives of contracts signed during the first year was 6.8 percent (slightly below the 7-percent limit). The average chargeable increase for both management and nonmanagement nonunion workers was 5.8 percent (substantially below the pay standard). The average downward adjustment to the average increase of 7.6 percent for all workers in the first year was 1.3 percentage points, which results in an average chargeable pay-rate increase of 6.3 percent.

The adjustments for each group are summarized in Table 5. (The components are described in detail in Appendix A.) This table shows that half of the discrepancy between reported actual and chargeable pay-rate increases is attributable to discrepancies between the COLA assumption stipulated by the standards and the evaluations made by the employers. As would be expected, this COLA adjustment was most significant in the case of union employee units, accounting for 1.5 of the 2.1 percentage points of adjustments for these workers; it was also important for the nonmanagement, nonunion units, accounting for more than a third of their total adjustment. The two "maintenance of benefit" adjustments for health insurance and pensions also contributed substantially to the disparities between actual and chargeable pay increases for all groups. The exclusion of overages attributable to formal annual pay plans announced before the beginning of the program were important for both categories of nonunion workers. The exclusion of promotions and qualification increases for employee units using the "fixed population" method of calculation was significant only for management units; exclusions for incentive pay, on the other hand, were a significant factor only for the nonmanagement, nonunion units.

Table 5.—Contributions of Various Components to Adjustments of Wages and Salaries [1] (FIRST PROGRAM YEAR)

	All workers	Union [2]	Management	Others
Total adjustment [3]	1.0	2.1	0.8	0.8
Contribution of: COLA evaluation	0.5	1.5	0.1	0.3
Maintenance of health benefits	0.1	0.2	0.1	0.1
Pension plans	0.2	0.2	0.2	0.1
Formal annual pay plans	0.1	NA	0.2	0.1
Excluded promotions and qualification increases	0.0	NA	0.1	0.0
Excluded incentive pay	0.0	0.0	0.0	0.1
Exceptions	0.1	0.3	0.1	0.1

[1] See Appendix A for descriptions of these adjustments.
[2] Annual average over the life of the contract.
[3] Components may not add to total because of rounding (effect of weighted average method is negligible, see Appendix A).

Each of the foregoing adjustments of actual pay increases was an integral part of the basic standard and was therefore self-administered by the companies. The pay standard also allowed for special exceptions for tandem relationships between different employee units, increases necessitated by acute labor shortages, the exchange of pay increases for phasing out of productivity-inhibiting work rules, and the correction of inequities. The slippage in the standards accounted for by these Council-granted exceptions was significant for all three groups, but it was much larger for the union groups than for management and nonmanagement, nonunion groups.

While much can be learned by examining the *averages* of the pay-rate increases, there is also something to be learned from the *distributions*. Figures 2, 3, and 4 show the distribution of both actual and chargeable pay-rate increases for all reporting workers, union employee units, and nonunion employee units. (We do not show distributions for the management and nonmanagement units separately because the two are similar.) In each case, the estimates are weighted by the number of employees in each compliance unit.

The top charts in the three figures show that unadjusted rates of pay increase were widely dispersed and often considerably above the 7-percent standard. The nonunion pay-rate increases roughly follow a normal distribution; the union increases, in contrast, are bunched in the 8½-to-9½-percent range.

As our foregoing discussion of the differences between reported actual increases and those chargeable under the standards suggests, the disparity in the rates of pay increase for union and nonunion workers is narrowed considerably by the removal of the portions that are not chargeable.

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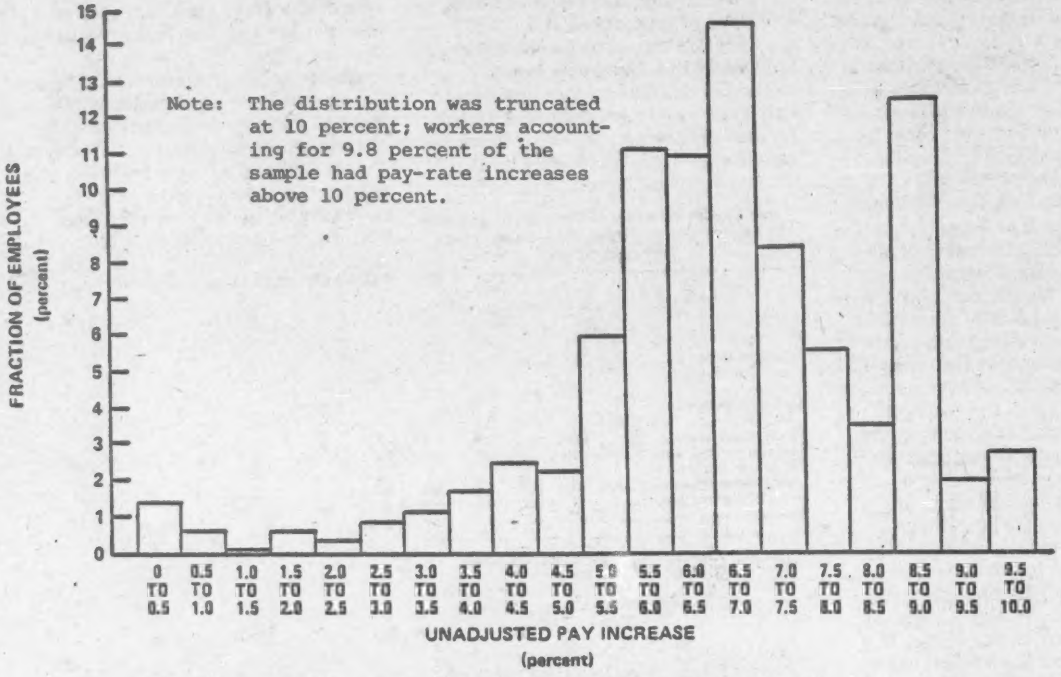
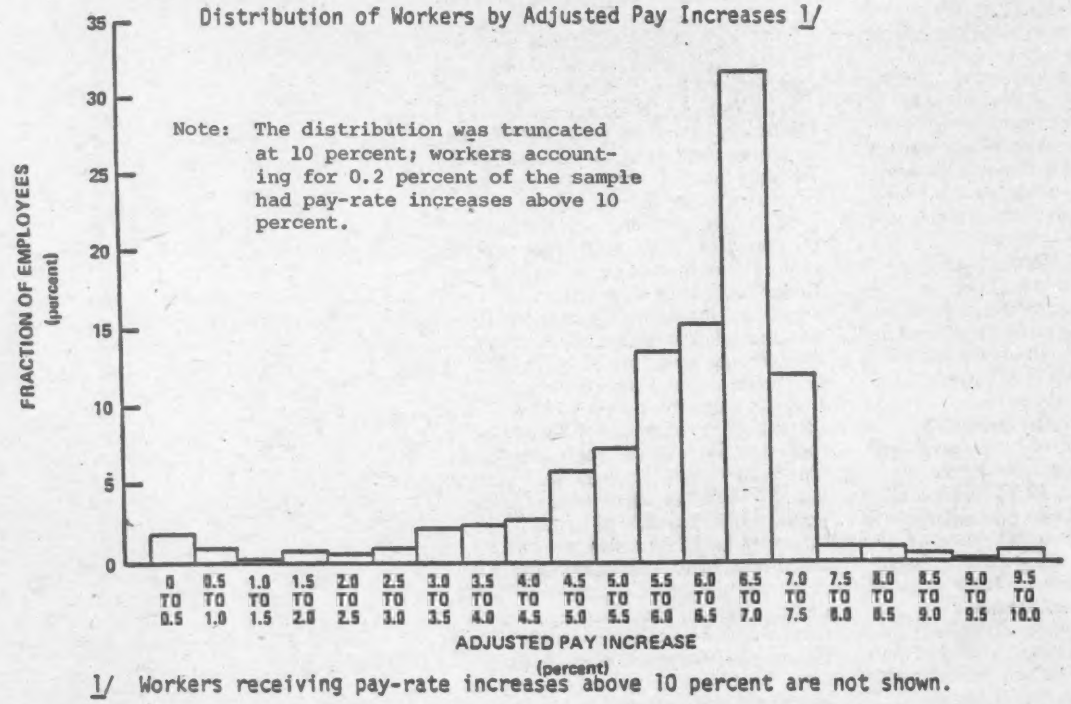
Figure 2

Distribution of Workers by Unadjusted Pay Increases 1/



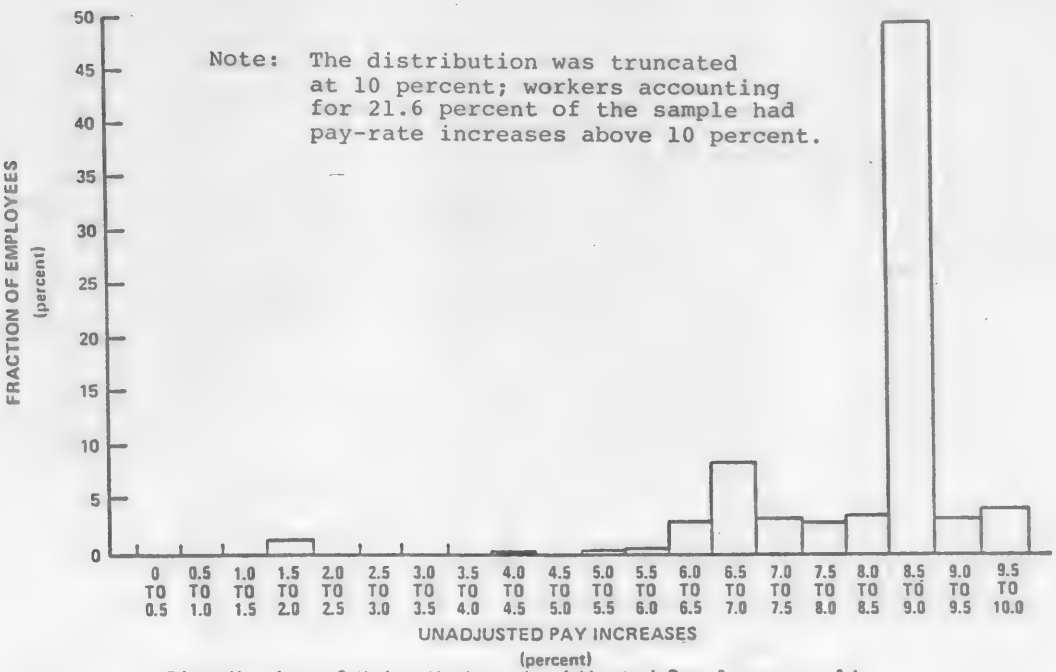
Distribution of Workers by Adjusted Pay Increases 1/



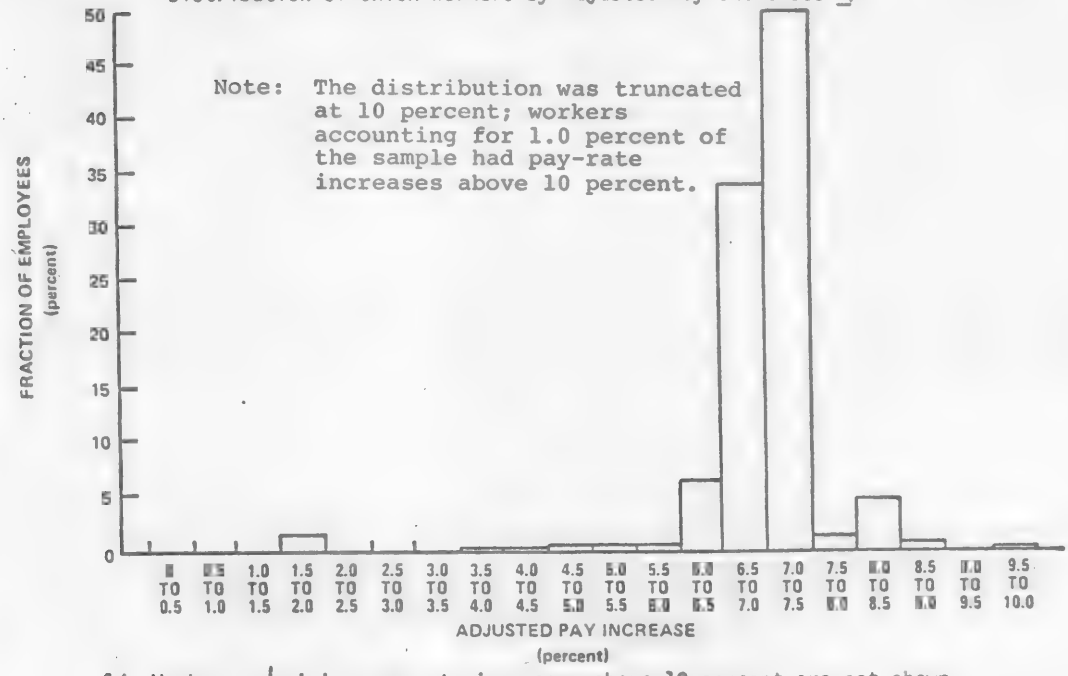
1/ Workers receiving pay-rate increases above 10 percent are not shown.

Figure 3

Distribution of Union Workers by Unadjusted Pay Increases 1/



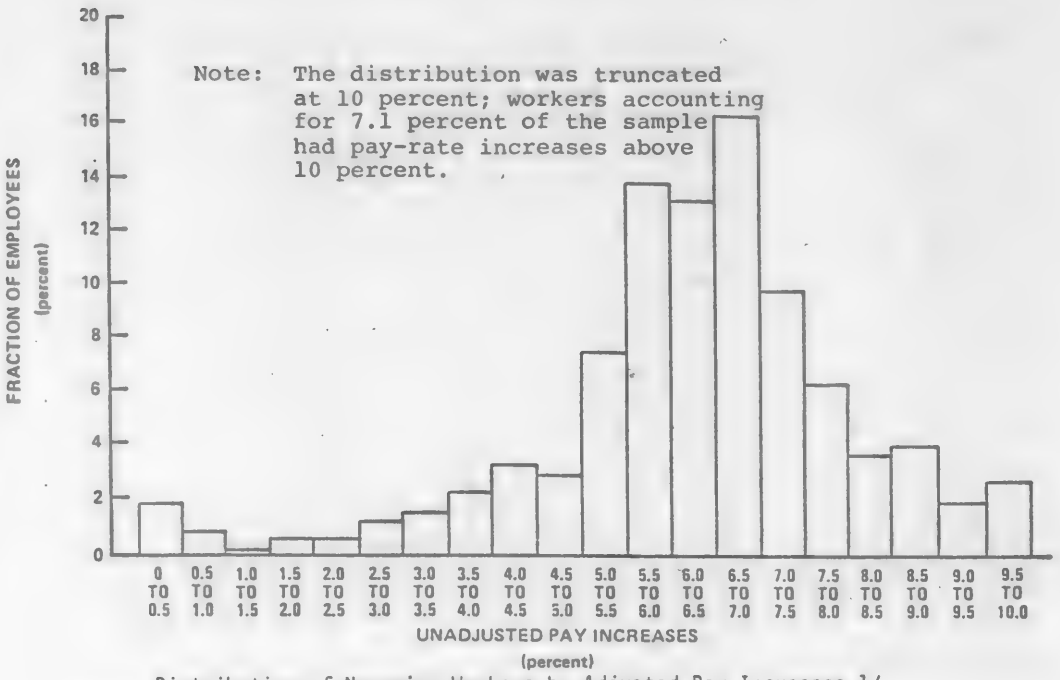
Distribution of Union Workers by Adjusted Pay Increases 1/



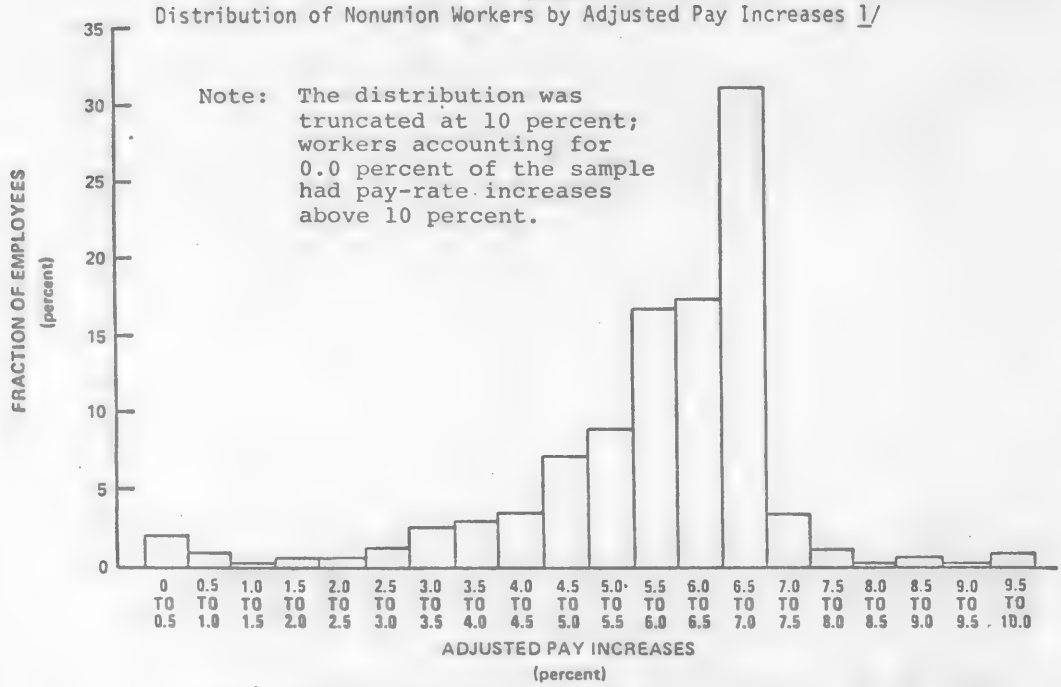
1/ Workers receiving pay-rate increases above 10 percent are not shown.

Figure 4

Distribution of Nonunion Workers by Unadjusted Pay Increases 1/



Distribution of Nonunion Workers by Adjusted Pay Increases 1/



1/ Workers receiving pay-rate increases above 10 percent are not shown.

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With these adjustments, almost a third of the nonunion workers are in the 6½-to-7-percent range, sixty-five percent are in the 5½-to-7-percent range, and only about 5 percent had increases of more than 7 percent. On the other hand, half of the union pay increases are slightly above the 7-percent standard—in the 7-to-7½-percent range. About 34 percent are slightly below the standard—in the 6½-to-7-percent range. The distribution of wage increases for union workers was heavily influenced by a number of major settlements that were slightly above the 7-percent standard. The most notable cases were rubber and autos, where the collective-bargaining agreements were found out of compliance but the companies involved were not listed as noncompliers because of their commitments to take corrective action (most frequently by exercising additional price restraint).

C. Analysis of Company-Specific Price Data

In the first program year, we asked all firms with sales of $250 million or more in the last complete fiscal year before October 2, 1978, to file price, gross-margin, or profit-margin data with the Council. Approximately 1,300 companies were of this size; in their reports they disaggregated their operations into 2,101 compliance units. In addition, we asked 235 smaller companies in selected industries to file price-monitoring forms (PM–1s).

Of the reporting compliance units, 801 filed under the basic price deceleration standard, 546 under the various gross-margin standards available to selected industries, 815 under the profit-margin limitation, and 9 under the professional-fee standard; 165 were exempted from the price standards because 75 percent or more of their revenues came from the sale of excluded products (see Table 6).

Table 6.—*Distribution of Number of Companies by Standard*

[First program year]

	Total by	Percent of total	No. of companies reporting by size of company		
			Over $500M	$250–$500M	Below $250M
I. Price deceleration	801	34.3	538	169	94
II. Gross margin	546	23.4	345	155	46
—Percentage gross margin	307	13.8	245	125	14
—Food mfg. proc. gross margin	91	3.9	68	20	3
—Refiners gross margin	68	2.9	32	7	29
III. Professional fee	9	0.4	4	4	1
IV. Profit margin	815	34.9	471	251	93
—CWPS granted/pending	206	8.8	181	21	2
—Self-administered	376	16.1	136	176	64
—Insufficient product coverage	234	10.0	152	54	17
V. Exempt	165	7.1	105	45	11
Total number of filings	2,336	100.1	1,463	638	285

The following analysis is based on samples of these PM–1 forms; not all of the forms have been entered in our computer file, in part because we did not require computer-compatible forms until the second quarter of the second program year.

During the first program year, 871 compliance units reported price data to the Council. (This number is greater than the 801 that filed under the price deceleration standard because it includes some compliance units that received exceptions, permitting them to file under the alternative profit-margin limitation, on the grounds of uncontrollable costs or inability to compute.) The revenue-weighted average price increase during the base period for a sample of 83 percent of these firms was 6.35 percent. This translates to a 5.8-percent average allowable price increase after account is taken of the required price deceleration of 0.5 percentage point and the maximum (9.5 percent) and minimum (1.5 percent) allowable program-year increases. This is virtually identical to the 5.75-percent average allowable increase that we estimated on the basis of aggregate data for the entire economy when the standard was first promulgated.

The fact that the actual average price increase of 9.36 percent for this group during the first program year far exceeded the 5.8-percent limit does not necessarily signify widespread noncompliance because many of these firms received exceptions to the price deceleration standard. Because this sample underrepresents compliance units that received profit-margin exceptions (since fewer of them filed price data) it cannot be used to estimate the slippage attributable to the availability of this exception.

When we remove from the sample the compliance units that received profit-margin exceptions, we find that the revenue-weighted average price increase of the remaining units during the first program year was 6.44 percent, as compared to an average allowable increase of 5.92 percent for this group (see Table 7). Compliance units accounting for 87 percent of the revenues in this sample reported price increases below their allowables. Moreover, the compliers were highly concentrated near those allowables: 50 percent of them were no more than a half percentage point below their ceilings. This suggests that the standard was constraining for a large proportion of the companies (see Figure 5).

Table 7.—*Compliance Units Filing Under the Price-Deceleration Standard*

	Revenue share [1]	Fraction of compliance units [2]	Average allowable price increase (percent)	Average actual price increase (percent)	Difference (percent)	Contribution to total price increase (percentage points)
	(1)	(2)	(3)	(5)	(6) (4)–(3)	(7)
Reported compliance with price standard	.8715	.8217	5.77	4.59	−1.18	4.00
Notices of probable noncompliance (sent or in process)	.0821	.0535	7.42	22.18	14.75	1.02
Under analysis	.0465	.1250	8.07	13.33	7.26	0.62
Total	1.0000	1.0000	5.92	6.44	0.52	6.44

[1] Total revenues (thousands) = $227,351,071.
[2] Total compliance units = 656.

Eighteen percent of the compliance units, accounting for 13 percent of the revenues, reported price increases above their allowables. Not all of them are out of compliance; many will ultimately be found to have properly self-administered exceptions, or to have been eligible for alternative standards, or to have misinterpretated the standards or made calculation errors.

Thirty-three notices of probable noncompliance have been sent, or are in process of being sent, to companies in this sample. Analyses of the other 84 cases of overage are continuing, usually in discussions with the company. Some of these discussions have resulted in the companies taking corrective action to come back into compliance. (There have been over 20 publicly announced corrective actions totaling over $130 million.)

The 6.44-percent price increase by compliance units in the sample that were not granted profit-limitation exceptions is, of course, considerably below the 12.5-percent increase in the CPI during the first program year. The 6.1-point difference between these two figures is explained by three factors: (1) The rapid increases in some components of the CPI that are not covered by the standards (most notably mortgage interest costs); (2) the passthrough of some large raw-material cost increases (most notably crude-oil costs) under the profit-margin limitation and the various gross-margin standards available to particular industries; and (3) some noncompliance.

We have already discussed the first of these, in contrasting the behavior of prices covered and the prices not covered by the standards. However, since the sample includes some compliance units that were eligible for alternative standards or that self-administered exceptions, the 6.44-percent price increase is not indicative of actual price increases by firms on the price deceleration standard. Thus, to estimate the slippage and noncompliance attributable to the profit-margin exception, we must restrict the sample of compliance units filing price data further to exclude all firms that were eligible for an alternative standard: this cuts the sample to 317. Compliance units in this sample that filed under the price deceleration standard had a revenue-weighted program-year price increase of 5.57 percent; their allowable increase was 6.61 percent. The concentration of the price increases of this group just below the allowable is even more promounced than in the larger sample (see Figure 6), probably because this smaller sample excludes many companies that have self-administered exceptions or that have converted to an alternative (gross margin) standard.

Compliance units in this sample that were granted profit-margin exceptions on average exceeded by 13.23 percentage points the price increases they would have been allowed had they remained on the basic price deceleration standard. (We cannot estimate the portions of this excess attributable respectively to noncompliance and to the fact that the profit-margin exception simply permits larger price increases.) Slippage and noncompliance thus contributed 4.66 percentage points to the total price increase for this group (obtained by multiplying 13.23 by the revenue share of companies under the profit-margin limitation).

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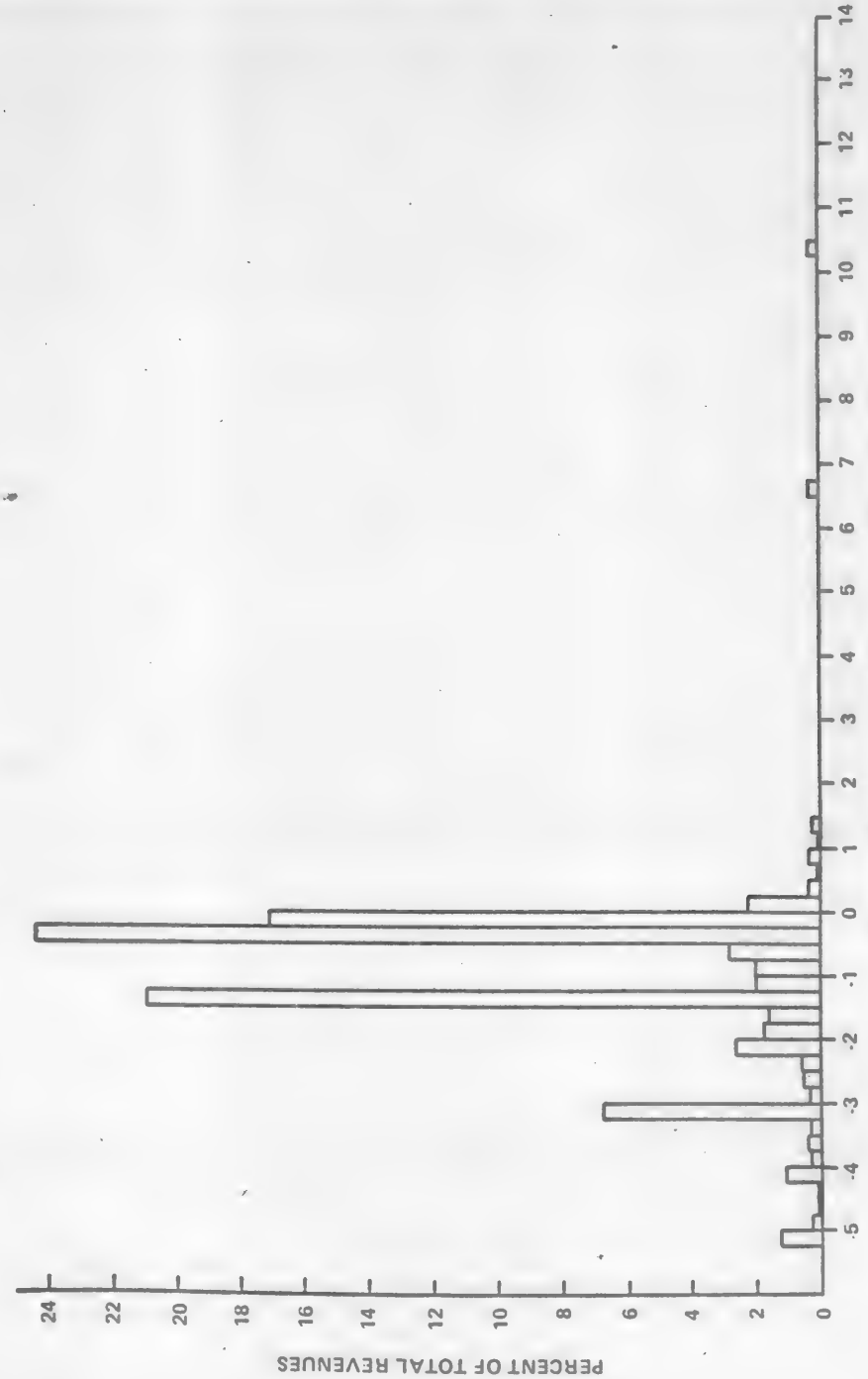
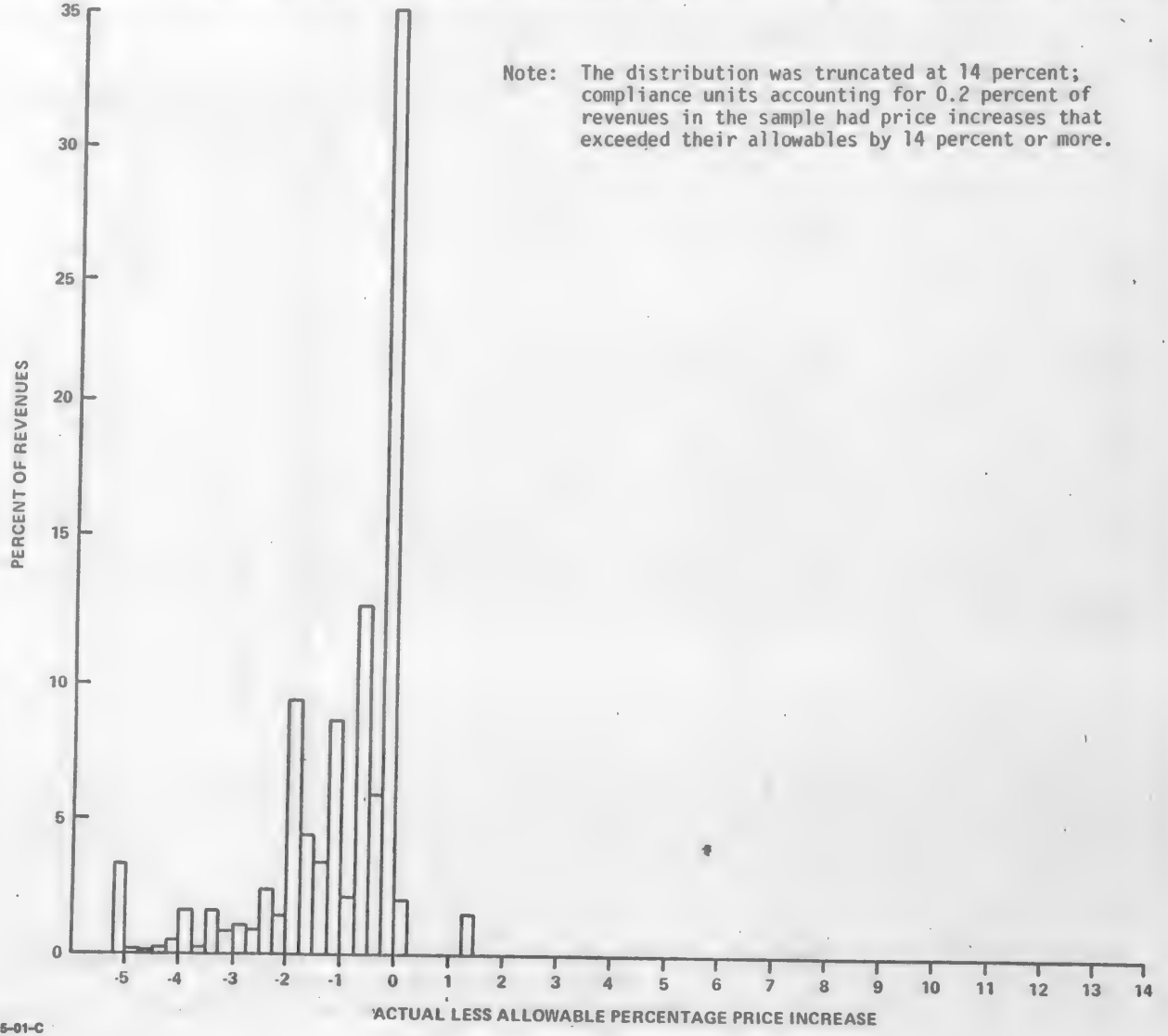
Figure 5

Distribution of Revenues by Difference Between Actual and Allowable Price Increases (All Compliance Units Filing Under the Price Deceleration Standard)



Note: The distribution was truncated at 14 percent; compliance units accounting for 5.77 percent of revenues in the sample had price increases that exceeded their allowables by 14 percent or more.

Figure 6
Distribution of Revenues by Difference Between Actual and Allowable Price Increase
(All Compliance Units Filing Under the Price Deceleration Standard that are not Eligible for an Alternative Standard)



Note: The distribution was truncated at 14 percent; compliance units accounting for 0.2 percent of revenues in the sample had price increases that exceeded their allowables by 14 percent or more.

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These calculations are summarized in Table 8. Compliance units under the price deceleration standard increased prices on average by 5.6 percent, whereas companies with profit-margin exceptions (to the price deceleration standard) increased theirs by 19.8 percent. Weighting these two figures by revenue shares, we obtain a total price increase of 10.6 percent. This increase, calculated from company specific data, is remarkably consistent with increases in comparable economy-wide price indexes during the first program year, which ranged from 9½ percent to 11 percent. The Gross National Product deflator rose 9.6 percent; the fixed-weighted Personal Consumption Expenditure Deflator increased 10.0 percent; the CPI less mortgage interest costs—which are not covered by the standard and are not passed through under the profit-margin limitation—rose 10.5 percent; and the Producer Price Index for finished goods increased 11.2 percent. This suggests that price increases of companies eligible for the various gross-margin standards—which are not included in our sample but are, of course, included in the comparable aggregate indexes—were roughly equivalent to those not eligible for these alternatives.

Table 8.—The Price Standard and Profit-Margin Slippage

	Price change	Contribution to total price increase [1]
Price-decelaration standard		
Allowable	6.61	4.28
Underage	−1.44	−.93
Excess	0.40	.26
Acutal	5.57	3.61
Profit-margin limitation		
Allowable	6.58	2.32
Slippage and Noncompliance	13.23	4.66
Actual	19.81	6.98
Total		10.59

[1] The contributions were calculated by multiplying the first column by the relative revenue shares of compliance units under the price deceleration standard and the profit-margin limitation (.6476 and .3524, respectively).

Because the average allowable price increase for compliance units not eligible for the alternative standards was 6.6 percent—about one percentage point above the 5¾ percent estimated average allowable for the entire economy—it would appear that compliance units eligible for the alternatives had below-average base-period price increases. This implies, in turn, that the noncompliance and slippage among companies eligible for the various gross margin test (i.e., the difference between their actual price increases and what they would have been allowed under the price deceleration standard) was greater than the slippage among companies that were not eligible for an alternative standard. This is no way to test this conclusion, because price data are not reported by compliance units under these alternative standards. We do know, however, that the combination of slippage and noncompliance in petroleum refining and marketing was much larger than 4½ percent—the estimated profit-margin slippage for compliance units not eligible for alternative standards—primarily becasue of the passthrough of a 56-percent increase in the cost of crude oil (see the Council's *Petroleum Prices and the Price Standards,* February 25, 1980). Similarly, the slippage in the food processing and distribution sector appears to have been about 5½ percentage points: aggregate data show a base-period increase of about 4½ percent and a program-year increase of 10 percent.

D. Conclusion

In this section, we have examined the efficacy of the standards program in restraining wage and price inflation. All of these analyses confirm our impression, based on day-to-day dealings with companies, that it has induced considerable restraint. Although the inflation rate accelerated markedly during the program period, most of this acceleration can be attributed directly to the passthrough of a surge in raw-material costs. We never expected the standards program to prevent such a passthrough, nor did we intend it to do so: any attempt to limit raw-materials costs or their passthrough would have produced serious distortions and shortages.

Our statistical analysis suggests that, had the standards not been in place during the year and a half ending in March 1980, the annual rate of increase of labor compensation would have been almost 2 percentage points higher, the underlying rate of inflation 1 to 1½ percentage points higher, and the overall inflation rate almost ½ to ¾ percentage point higher.

The social benefits of the program depend, of course, on the gains from reducing inflation. Such gains cannot be measured directly. If, however, we are willing to take as given the social commitment to lower the inflation rate, then we can measure the benefits of the program by referring to the social costs of reducing the inflation rate by alternative methods—namely, additional fiscal and monetary restraint. A conservative estimate, based on recent econometric evidence, is that, in order to generate a sustained lowering of the underlying inflation rate of 1 percentage point by fiscal and monetary restraint alone, we would have to increase the unemployment rate by 1 percentage point. This translates into a 2-percent reduction in output, or 47 billion dollars of lost GNP. These estimates are, of course, inferential and are subject to statistical error; nevertheless, even if they were off by several orders or magnitude, the social benefits of the standards program would remain extremely large.

The social costs of the program are much harder to quantify; they are reflected in the administrative burdens imposed on companies and in any loss of output caused by induced economic inefficiencies and market distortions. (The directly measurable costs of the program as reflected in the Council's budget are miniscule compared to the apparent social benefits.) Perhaps because of the substantial flexibility in the standards, however, we have seen no convincing documentation of significant induced inefficiencies.

Of course, documentation that the pay and price standards were beneficial during the first year and a half does not, in itself, demonstrate that they should be continued. The critical question is whether or not these standards can continue to be a potent force for wage and price restraint in the year ahead. The answer to this question depends in part on economic conditions during the next year and in part upon the degree to which strains within the standards program have made it less viable.

There is now a consensus view that the economy has moved into a recession. It may be argued that standards are not needed during recession because market forces will restrain pay and price increases. On the other hand, it can be argued that standards are most needed during a slowdown or a recession in order to make the slowdown work as much as possible toward reducing the underlying inflation rate. This argument is especially forceful when the recession takes place in the aftermath of a large increase in consumer prices, because these increases continue to provide pressures to increase wages in order to catch up for past decreases in the standard of living, despite the fact that labor markets are weakening. Finally, it can be argued that it is necessary to keep the standards in place to prevent another serious surge of inflation when the economy begins to recover in late 1980 or early 1981, particulary since the underlying rate of inflation is expected to hover near double-digit rates through most of the recession.

III. Major Issues in the Design of the Third-Year Price Standards

A. Threshold Issues

The foregoing analysis suggests that the standards have helped to limit the rate of inflation. Because inflation continues to be a serious problem, despite the onset of recession, we expect that the pay/price-standards program will be continued. We recognize factors which suggest the opposite, however. There is some basis for the view that the effectiveness of programs like these may diminish over time and that the distortions and inefficiencies they introduce—no matter how flexible their design and administration—become increasingly burdensome. In addition, the recession may tend to make such standards less useful. While, therefore, we expect to carry the present program into a third program year, we solicit public comment on the general question of whether a third year of pay and price standards following the general outlines of the first two years is a useful component of an anti-inflation program. We ask that those who respond in the negative give serious consideration to what alternative program, if any, would be more desirable.

Assuming that the present program is continued, there is another threshold question that must be resolved before deciding the form of the third-year standards: whether it is better to proceed, as in the past, with standards for a 12-month period, or alternatively, whether they should be reevaluated (and modified, if appropriate) within a more limited period of time (e.g., quarter by quarter or every six months). While it can be argued that more frequent modifications are preferable, especially in times when the economy is in an unusual state of flux, the mere possibility of changes in the standards during the year would subject companies to greater uncertainty and render them unwilling or unable to develop effective long-term compliance plans. And, if a major program change were in fact made, it would impose substantial additional administrative costs on both the companies and the Council.

In any event, retaining a 12-month concept for the third program year would not preclude us from modifying the standards during the year if changing economic conditions made this advisable. During the past year, for example, we initially set the third-quarter price limitation at the same level as for the entire two years, but at the same time announced that, if price developments earlier in the year suggested the need for more restrictive quarterly limits, the third-quarter ceiling might be adjusted downward. And then, in late March, after the annual rate of increase of the CPI reached 18 percent, we announced a tightening of the third-quarter limit. Similarly, we could loosen the standards within the framework of an annual program. For example, during this past year, we developed a modified standard for companies that use a significant amount of gold and/or silver, and we adjusted the price limitation for airline companies that had experienced large increases in fuel costs.

Assuming that we retain a 12-month program period, the remaining price-standard issues are best considered in the following order: (1) The price limitation versus cost passthrough, (2) the level of the aggregate price standard, (3) the choice of a base period, (4) adjustments to the base period, (5) the range of allowable price increases, (6) a one-year versus a three-year cumulative standard, (7) changes in the profit limitation, (8) excluded products, (9) modified price standards, (10) company organization, (11) self-administration of uncontrollable-cost exceptions, and (12) price prenotification. In discussing these issues and expressing our preferences for particular resolutions, we are influenced by the consideration that the less radical and extensive the changes, the more both the Council and the affected companies can benefit from their experience over the past two years. At the same time, some changes are necessary, and others might even reduce the administrative costs of the program.

B. Specific Issues

1. *The Price Limitation versus Cost Passthrough.* The basic price limitation is cast in terms of a company's average rate of price change for all of its products. This approach gives companies maximum opportunity to adjust their *relative* prices in response to varying demand and supply conditions, while providing for *overall* restraint in their pricing. The second-year standard limited a company's average rate of price increase over the first two program years to its average increase over the two-year base period. It has been suggested that this standard should be replaced by one permitting passthroughs of all costs (like the current profit limitation), rather than having profit restrictions apply only when companies are faced with uncontrollable cost increases or are unable to make price calculations. In the past, we have rejected this suggestion, preferring the price limitation for the following reasons:

- Price limitations involve fewer accounting complications and are easier to monitor than cost passthroughs.
- Price limitations do not vary with changes in costs. This provides companies with incentives to resist cost inflation.
- Price limitations permit firms the full benefits of increased productivity.
- So long as exceptions are provided for companies that cannot comply with the price limitations because of uncontrollable cost increases, there is no inherent inequity in having the price limitation as the basic standard. The Council has approved exceptions for full cost passthrough in individual cases and has approved passthroughs of particularly large, uncontrollable increases in the costs of specific inputs (e.g., gold and silver, and airline fuel).

These last specific adjustments demonstrate our commitment to enabling companies to remain on the price limitation, rather than their resorting to the cost-plus-profit limitation. It was to improve the likelihood of their being able to do so that the Price Advisory Committee recently recommended that we revise the overall price limitation upward for all companies to reflect the recent increase in the pay standard to the 7½-to-9½ percent range. In declining to follow that recommendation, we reasserted our preparedness to adjust price limitations for individual companies or industries on an *ad hoc* basis to account for unusually severe increases in cost, whether of labor or other inputs. We renew that pledge, and invite reasonable proposals to accomplish this objective.

2. *Establishing the Level of Aggregate Price Standard.* For the first and second program years, the aggregate price standard was derived from the pay standard, assuming a constant percentage markup of prices over unit labor costs (i.e., constant labor and nonlabor income shares) and a trend productivity growth rate of 1¾ percent (the average increase during the previous 10 years). If the nexus is retained in the third year, three determinations must be made: (1) The level of the pay standards, (2) the estimate of trend productivity, and (3) the difference in the amounts of slippage inherent in the pay and price standards.

The pay standard now in effect is a range of 7.5 percent to 9.5 percent. Under it, annual pay-rate increases are expected in normal circumstances to average about the midpoint of the range.

As a result of the recent collapse in productivity growth, the 10-year-average measure of trend productivity growth has decreased from 1.74 percent in 1977

to 1.35 percent in 1979. Some argue for the use of a more recent time period for calculating this variable, on the ground that the 10-year average overstates the current trend rate.

Conceptually, the measure of trend productivity should be based on relatively recent data, which are more relevant to current costs and pricing decisions. At the same time, the data must extend over a period sufficiently long to encompass experience from both the expansionary and contractionary phases of the business cycle, in order to produce a measure that is relatively stable and insensitive to cyclical influences.

The Council chose the 10-year period because it met these objectives. The ten years ending in 1977 incorporate approximately two complete business cycles and produce a relatively stable index. This can be seen clearly in Figures 7 and 8, which compare a ten-year trend with a six-year and a four-year trend, respectively.

Assuming an 8.5-percent pay standard and equal slippage for pay and price, the aggregate price standard for various productivity growth trends would be as follows:

Productivity trend:	*Aggregate price standard*
1.75 (current assumption)	6.75
1.35 (new 10-year trend)	7.15
1.25 (4-year trend)	7.25

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Figure 7
Growth Rate in Output Per Hour, All Persons, Private Business Sector
(annual data)

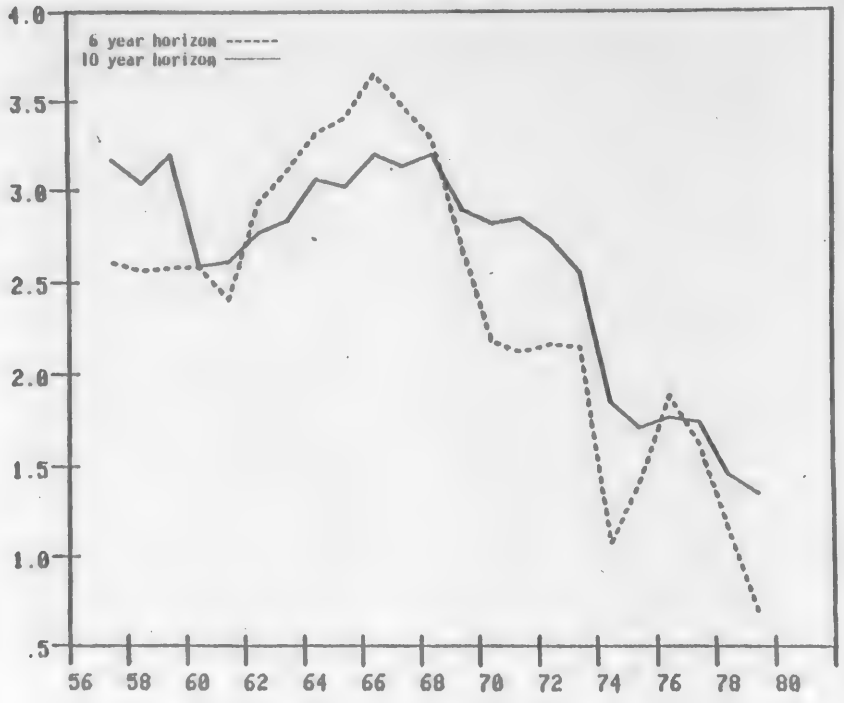
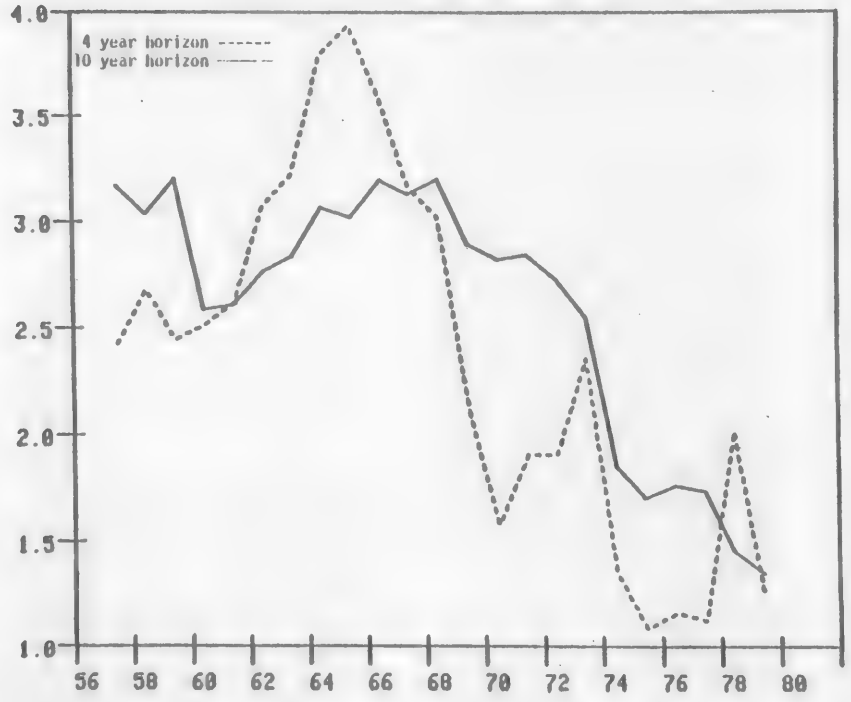


Figure 8
Growth Rate in Output Per Hour, All Persons, Private Business Sector
(annual data)



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As noted in Section II, the apparent slippage on both the pay and price sides during the first program year was about 1½ to 2 percentage points. Most of the slippage in the price standard is attributable to the passthrough of substantial raw-material cost increases; a large portion of the pay slippage resulted from a 9.4-percent increase in the minimum wage, which affected the wage increases of the 35 percent of the workforce excluded by the low-wage exemption. There should be less slippage in the pay standard during the second and third program years, because the minimum wage increased by only 6.9 percent in 1980 and will go up by 8.0 percent in 1981; both increases are below the 8.5-percent midpoint of the current pay-range standard. There should be less slippage on the price side as well, because raw-material price increases should be much more moderate as world economic growth slows. Whether the equality of slippage in the pay and price standards can be expected to continue is uncertain.

Once an aggregate level is established, the next step is to compare it to the aggregate base-period price change and then translate that into company-specific price limitations. Thus, for the first two program years, the aggregate two-year price standard was 13 percent; because the aggregate price change during the 1976–77 base period also was 13 percent, the two-year price limitation for each company was set equal to its cumulative price increase over the 1976–77 period.

Similar logic would be followed to establish company-specific third-year price limitations. The three-year aggregate standard would be calculated by compounding the aggregate two-year standard (13 percent) with the aggregate price standard for the third year. For example, if a 7.15-percent standard were chosen for the third year, the aggregate three-year price standard would be 21.1 percent (([1.13 x 1.0715]−) x 100).

The difference between the aggregate three-year standard and the base-period rate of price increase compounded over three years (20 percent) would be used as the adjustment factor to calculate company-specific three-year price limitations. Continuing the above example, we subtract 20.0 percent from 21.1 percent to obtain the adjustment factor of 1.1 percentage points. Thus, an individual firm would calculate its allowable three-year price increase by compounding its average annual base-period price increase over three years and adding 1.1 percentage points.

3. *The Choice of a Base Period.* The logical structure described in subsection 2 implicitly assumes that there is some continuity over time in the differences among companies and industries in their respective productivity and cost trends, and that their relative price changes in the recent past adequately reflect these differences. In other words, the standard assumes that, in general, industries that experienced relatively rapid productivity growth (hence low rates of cost increase and low rates of price increase) in 1976–77 will continue to do so during the program period and that their allowable price increases should be correspondingly lower.

For the first and second program years, we selected the 1976–77 two-year period as the reference period for calculating the price limitation. We excluded earlier years because underlying cost trends had been distorted by the 1974–75 recession and the large energy price increases in 1973/74. We excluded the period since 1977 to avoid penalizing companies that had reduced their rates of price increase in cooperation with the Administration's informal program, announced in January 1978.

These advantages of 1976–77 as a reference period are still valid for the third program year. Moreover, retaining the same base period for the third program year minimizes the administrative costs of the program for both companies and the Council.

There is some sentiment, however, for moving the base period forward on the ground that it would then more closely reflect current cost trends and product mixes. Such a change also would expand the coverage of the program by including products introduced and companies formed during the first two program years.

Nonetheless, incorporating 1978 in the base period would be inequitable, for it would penalize companies that had exercised price restraint under the Administration's anti-inflation program during that period. Incorporating 1979 would be even more unfair; companies that had conscientiously complied with the first-year standards would have relatively lower allowables than those that had not complied. Moreover, if the base period were moved forward enough to encompass the explosion in energy and other raw-material costs, it would be equally unrepresentative for a program period in which the raw-material price increases are expected to abate. Finally, changing the base period would impose additional costs on companies—which would have to recalculate their base-period price changes—and on the Council—which would have to process the revised data.

4. *Adjustments of the Base Period.* While the base period is suitable for the vast majority of companies, we recognize that in individual instances a company's base period may not adequately represent its normal cost/revenue relationships. We anticipated such problems by providing undue-hardship and gross-inequity exceptions designed in part to provide relief in the case of unrepresentative base periods. It has, however, taken us more time than expected to formulate criteria for such relief, because of the difficulty of defining criteria that would permit desirable adjustments without opening gaping loopholes.

Toward the end of the first program year, we began making adjustments for unusual and nonrecurring events during the base period—e.g., unusually high start-up costs, floods, fires, and strikes. More recently, we have provided relief for companies whose base-period profits were temporarily depressed because of readily identifiable, transitory, noncyclical developments.

Other criteria for adjusting base periods have been suggested to us but not accepted. For example, some companies have asked that they be allowed to raise their profit margins to an industry-wide average. This would have the effect of substantially increasing the average profit margin, because, of course, every company below the average would move up to it whereas no company above the average would be forced to come down to it. The result of such a universal acceptance of the propriety of catch-ups would be a slippage in the standards so serious as to threaten their effectiveness.

It has also been suggested that base-period adjustments be allowed for any company (or compliance unit) that incurred a loss during the base period. We acknowledge that a loss position cannot typically be representative of a viable long-term operation. Nevertheless, the Council has not automatically made adjustments in such cases, for several reasons. First, it is not necessarily an undue hardship for a compliance unit that is part of a larger company to be in a loss position; many companies may carry nominally losing operations for considerable periods of time for valid business reasons. Second—and more important—it is difficult, if not impossible, to develop workable and equitable criteria for an adjustment. Zero growth in profits might sound more reasonable than a negative number, but those who object to a negative number would surely object also to zero. Moreover, it is arbitrary to distinguish between companies slightly below and those slightly above zero. The only logical outcome of that process

would be something that also has been suggested—that the Council set "reasonable" rates of return for companies with negative—or low—base-period profits. It seems clear, however, that we will not allow ourselves to be drawn into rate-of-return regulation for large segments of the economy.

Although none of the base-period adjustments made by the Council to date have involved the price limitation, we have adjusted program-year price changes to achieve the same result, as in the above-cited cases of airline companies and companies using substantial amounts of gold and/or silver.

We believe that adjustments of base-period data will be increasingly important in the third program year, because the inequities caused by unrepresentative base periods cumulate the longer companies are constrained by their base-period performance. We therefore strongly urge public comments on possible ways of accomplishing this without gutting the standards.

5. *The Range of Allowable Price Increases.* During the first program year, a company's average price increase was not held below 1½ percent, and not permitted about 9½ percent, whatever its base-period rate of price change. In the second year, we narrowed that range to avoid inequitable treatment of firms with very low base-period rates of change without unduly relaxing the standard; specifically, we set the price band at 3½ percent to 8½ percent for the second year alone. Because the second-year standard was a cumulative two-year limitation, the range of allowable price increases for the two years was 5 percent to 19 percent.

To determine the range of allowable price increases for the third year, it is instructive to examine the relationship between alternative ranges and levels of the aggregate price standard. Clearly, raising (lowering) either of these bounds increases (decreases) the aggregate price standard. Table 9 shows the level of the aggregate price standard for various values of the upper and lower bounds, assuming that the allowable rate of increase is set equal to the base-period rate of increase (of course, subtracting a "deceleration" factor would lower each value in the table by the amount of the deceleration factor). The constructed values are based on a sample of 727 compliance units.

Changing the bounds within moderate ranges has little effect on the aggregate price standard. For example, the change in the bounds from 1½ percent and 9½ percent in the first year to 3½ and 8½ percent in the second year had no effect on the aggregate price standard; both pairs yield an aggregate price standard of 6.27 percent (assuming no change in the deceleration factor). Note also that this figure differs little from the aggregate price standard with no upper or lower bound (6.35 percent).

Table 9

Relationship Between Alternative Ranges of Allowable Price Increases and the Aggregate Price Standard 1/

Alternative Lower Bounds	Alternative Upper Bounds					
	No Upper Bound	9.5	9.0	8.5	8.0	7.5
No Lower Bound	6.4	6.1	6.1	5.9	5.8	5.5
1.5	6.5	6.3	6.2	6.1	5.9	5.7
2.0	6.5	6.3	6.2	6.1	5.9	5.7
2.5	6.5	6.3	6.3	6.1	5.9	5.7
3.0	6.6	6.4	6.3	6.2	6.0	5.8
3.5	6.7	6.5	6.4	6.3	6.1	5.9
4.0	6.8	6.6	6.6	6.4	6.2	6.0
4.5	7.0	6.8	6.7	6.6	6.4	6.2
5.0	7.2	7.0	6.9	6.8	6.6	6.4

1/ Based on a sample of 727 compliance units with total sales of $264 billion. The entries in the matrix are levels of the aggregate price standard, assuming no deceleration or acceleration from the base period.

Of course, the upper and lower bounds are not used to set the aggregate price standard; rather, they are intended to change the distribution of allowable increases for reasons of equity. The number of compliance units affected by changes in the range can be determined by reference to the cumulative distribution in Table 10. For example, raising the lower bound from 1.5 percent to 3.5 percent increased the proportion of units affected from 14 percent to 25 percent, but lowering the upper bound from 9.5 percent to 8.5 percent decreased the proportion of units affected from 86 percent to 77 percent.

Table 10—*Cumulative Distribution of Compliance Units by Base-Period Rate of Price Change* [1]

Base-period rate of price change	Percentage of compliance units
less than 0.0	[illegible]
0.0 to 0.5	10.1
0.5 to 1.0	12.1
1.0 to 1.5	14.3
1.5 to 2.0	17.5
2.0 to 2.5	19.7
2.5 to 3.0	[illegible]
3.0 to 3.5	25.3
3.5 to 4.0	27.3
4.0 to 4.5	[illegible]
4.5 to 5.0	35.7
5.0 to 5.5	41.2
5.5 to 6.0	[illegible]
6.0 to 6.5	52.6
6.5 to 7.0	[illegible]
7.0 to 7.5	[illegible]
7.5 to 8.0	70.2
8.0 to 8.5	77.1
8.5 to 9.0	81.6
9.0 to 9.5	[illegible]
9.5 to 10.0	[illegible]
10.0 to 10.5	[illegible]
10.5 to 11.0	[illegible]
11.0 to 11.5	89.3
11.5 to 12.0	[illegible]
12.0 to 12.5	[illegible]
12.5 to 13.0	90.8
13.0 to 13.5	91.4
13.5 to 14.0	[illegible]
14.0 to 14.5	92.4
14.5 to 15.0	92.6
15.0 to 15.5	92.8
15.5 to 16.0	[illegible]
16.0 to 16.5	[illegible]
16.5 and above	100.0

[1] Based on a sample of 727 compliance units with total sales of $264 billion.

6. *One-Year versus Cumulative Standard.* There are essentially two choices for the design of the third-year price standard: (1) A one-year limitation on price increases, measured from the fourth quarter of the second program-year to the corresponding quarter of the third year; or (2) a cumulative three-year limitation, measured from the calendar or fiscal quarter immediately preceding the first program year (the base quarter) to the corresponding quarter in the third program year. A variation of the second

approach would be to have a three-year cumulative limitation but to use the fourth quarter of a company's second program year as its base quarter for calculating its third-year increases.

A one-year limitation, by making the third-year limitation independent of actual and allowable increases in the first two program years, would eliminate complexities caused by the need to link changes in prices, gross margins, or profits of compliance units that comply with different standards in different years. It also has the advantage of moving the base quarter closer to the program year. This would expand the coverage of the program because it would permit the inclusion of products introduced, and companies formed, during the first two years. In addition, because the base-quarter product mix is used to calculate program-year price increases, using a more recent base quarter should reduce problems created by changes in product mix since the third quarter of 1978. However, a one-year limitation would penalize companies that did not increase prices as much as their allowable during the first two years, and obviously benefit those who exhausted—or exceeded—their two-year allowables. This would, in turn, provide incentives for companies to use all of the allowable increases in subsequent periods—an inflationary outcome that the Council is determined to avoid.

A cumulative three-year limitation has the advantages of familiarity and continuity; most important, it does not penalize those who did not use all of their allowables. Also, as noted above, it is possible to have a three-year cumulative standard and designate the fourth quarter of the second program year as the base quarter for calculating the third-year price increases, thus permitting coverage of new products and companies and the use of more current product mixes. Incorporation of that property into a *cumulative* (as opposed to a one-year) standard would thus combine the principal advantages of one-year and three-year limitations.

7. *Changes in the Profit Limitation.* During the first two program years, a profit limitation was available to compliance units unable to comply with the price limitation or other price standards because of an inability to calculate price changes or gross margins or because of uncontrollable increases in the prices of purchased goods and services. It was essential to have an alternative limitation available because large numbers of compliance units were faced with mounting cost pressures during 1979 and 1980.

The profit limitation is intended to constrain increases in price approximately to the increases in costs (thus preserving income shares). The second-year limitation consists of two tests, both of which must be satisfied. The first, which is unchanged from the first year, is that the profit margin for the second program year should not exceed the sales-weighted average profit margin for the best two of the compliance unit's last three fiscal years completed before October 2, 1978. The second test, which was tightened for the second program year, is that the compliance unit's second-program-year dollar profits should not exceed its base-year profits by more than 13.5 percent plus any positive percentage growth in physical volume from the base year to the second program year. Base-year dollar profits can be either (1) actual base-year profits or (ii) base-year revenue times the average of the base-year profit margin and the best-two-out-of-three-year average profit margin. In the first year, compliance units were allowed to use the full best-two-out-of-three-year profit margin in calculating base-year dollar profits, rather than having to average it with the base-year profit margin. We estimate that the asymmetry inherent in both of these definitions of base-year profits—allowing companies an upward adjustment if their base-year margin is below the best two out of three (effectively allowing "catch-up"), but not requiring a downward adjustment if the base-year margin is above the best two out of three—resulted in potential slippage a little less than half a percentage point. Companies that qualified for the profit-margin limitation were allowed to increase prices, on average, by an additional 1.3 percentage points because of the optional adjustment of base year profits. Weighting this slippage by the revenue share of companies under the profit-margin limitation, we obtain the above estimate of potential overall slippage (for all companies). Of course, the actual slippage was less than the potential because market conditions did not allow all companies to capitalize fully on the catch-up allowance. The second-year revision cut this potential slippage in half.

a. *Extent of "catch-up".* The extent to which the dollar-profit test permits a partial "catch-up" continues to be a matter of concern. As noted above, it grants some compliance units more than a passthrough of costs plus the stipulated percentage growth in profit. It may, therefore, be desirable to modify the profit limitation further by eliminating the alternative calculation, by simply reducing the amount of allowable "catch-up" from 50 percent to some lesser number, or by making the adjustment mandatory (requiring downward as well as upward adjustments).

b. *Choice of the base period.* During the first two program years, a compliance unit could choose any two of the last three fiscal years before October 1978 as its base period for profit calculations. We recognize that this period necessarily includes at least part of 1975, a recession year, and could include part of 1978, during which an informal anti-inflation program was in effect. Nevertheless, the two-out-of-three option eliminates the adverse effect of any unusual profit margin that might have occurred during one year of this period.

As with the base period for price calculations, the base period for the profit limitation could be moved forward. This, however, would create the same inequities as would a shift in the base for the price limitation, and would not necessarily better reflect current cost trends. In individual cases where the base-period results are clearly unrepresentative of normal operations and produce serious inequities, we have made adjustments (see Section 4), and will continue to do so.

c. *Requiring volume adjustments.* As currently drafted, the profit limitation provides for an upward adjustment of program-year dollar profits if a compliance unit experiences an increase in physical volume. If volumes decline, however, a compliance unit need not make any downward adjustment. Whether or not the standard should be symmetric—that is, an adjustment for volume be made mandatory in both directions—may be significant in the third program year, because significant declines in sales volumes are likely to take place during the recession. The principal problem with a mandatory volume adjustment is that many companies cannot readily develop physical volume indexes; indeed, many

are under the profit limitation for precisely this reason.

d. *Treatment of interest expense.* The definition of profit under the profit limitation includes interest expense—that is, interest must be added to profits in calculating the profit margin. The principle underlying this requirement is neutrality with respect to alternative forms of capitalization. That is, we wanted to avoid favoring one form of financing over another, and excluding interest expense (i.e., treating it as a cost, which can be passed through) would favor debt, as opposed to equity, financing. This approach had profound implications for many companies complying with the profit limitation because of the surge in interest rates during 1979 and early 1980. Particularly affected were retailers, who typically incur large short-term debt to finance inventories and accounts receivable; companies with primarily long-term debt—principally for capital investment—are less affected by short-term fluctuations in interest rates.

Two alternatives to the Council's approach have been suggested: (1) Excluding all interest expense and (2) excluding short-term interest expense. As we have observed, the first of these would discriminate against equity financing (although many would contend that neutrality requires inclusion of rental expense as well as interest expense to avoid discriminating against companies that purchase—rather than rent—structures). The second alternative was adopted in the Nixon Administration's Economic Stabilization Program and seriously disrupted capital markets by creating incentives for short-term financing of even long-term capital projects.

Finally, the sharp downturn in interest rates, which is expected to continue throughout the recession, should make this issue less pressing in the third year. Nonetheless, we solicit public comment on this question.

e. *Adjustments for productivity.* In designing the standards, we have been cognizant of the danger that government interventions like this one can cause inefficiencies. We have been particularly concerned about possible inhibitions of incentives to engage in productivity-improving capital investment. This is a matter of special concern because productivity growth is an effective antidote to inflation, in that it provides a buffer between increases in labor compensation and increases in unit labor costs. Indeed, the recent collapse of productivity growth has been an important contributor to our current inflation problem.

Our concerns are manifested in the standards in various ways, the most important of which is the selection of the price limitation, rather than cost-passthrough, as the basic standard. As we have already observed, companies that meet the basic price test reap the fruits of higher productivity growth in the form of higher profits. On the other hand, cost-passthrough limitations—whether of the profit-margin or gross-margin variety—dilute companies' incentives to engage in costly projects that could improve productivity, for two reasons. First, in many instances, those standards permit passthroughs of the costs that the projects might save. Second, investment prospects may require wider profit or gross margins if the additional investment is to be profitable, or even feasible.

Unfortunately, universal reliance on a price limitation is not feasible because of the need for relief for companies experiencing uncontrollable cost increases. As a result of the world-wide explosion of raw-material costs in 1979 and 1980, many companies were forced to resort to the alternative profit limitation. In addition, gross-margin standards—which provide for passthrough of some, but not all, costs—were developed for certain industries with highly volatile material input costs.

Those who contend that the profit-margin and gross-margin standards have, in fact, inhibited capital investment have suggested that a special adjustment to allowable margins be made for improvements in productivity. In fact, the mix adjustments currently available under the gross-margin standard for petroleum refiners partially compensate for investments that result in changes in the mix of feedstock inputs or refined products. This procedure, and modifications of it, are considered in subsection 9c. Similar adjustments could be applied more generally.

If adjustments were made for every capital investment program or for every improvement in productivity, however, the restraining effect of these alternative limitations would be severely weakened. Moreover, such adjustments would discriminate against companies in industries where the opportunity for substitution of capital for other inputs and/or for productivity improvement is relatively limited. In some high-technology industries, rapid productivity growth is commonplace; in other industries the technology simply does not lend itself to appreciable improvement. Nevertheless, because of the paramount social importance of revitalizing productivity growth, we modified our procedures at the beginning of the second program year to provide that, when the Council grants a request for approval of an exception, it may modify the exception to make allowances for documented extraordinary improvements in productivity that are demonstrably attributable to unusual capital expenditure programs. We anticipated that such a provision would produce a variety of requests, on the basis of which we could formulate criteria that could contribute to productivity growth without producing unacceptable slippage in the program. It elicited only a handful of requests, however—all of them received only recently.

8. *Excluded Products.* Agricultural, fishing, forestry, and mineral products falling within specified groups in the *1972 Standard Industrial Classification Manual* were excluded from the program during its first and second years. The reason for providing an exclusion was, in the case of most of these products, that their prices are set in competitive markets, in which sellers have little control over prices and in which price ceilings might possibly give rise to damaging shortages. The reason for relying on the SIC manual is that its classification scheme is well-known, well-understood, and easily administered.

While we are confident that the broad policies underlying both the exclusion and our reliance on the SIC manual are sound, we invite comment on whether the provision should be redrawn to include products now excluded or to exclude products now included.

9. *Modified Price Standards.* We developed the modified price standards as alternatives for industries for which the price standard is unsuitable. This is the case where (1) price-change indexes are too difficult or burdensome to compute, (2) raw-material costs are highly volatile, or (3) market characteristics necessitate special treatment. Modified standards are available for a number of kinds of companies, including retailers and wholesalers, food manufacturers and processors, petroleum refiners, electric, gas, and water utilities, insurance companies, professional firms, and financial institutions. A discussion of suggested revisions of some of the modified standards follows (no issues have yet been identified for the insurance (705.48 and 705.49), financial-institution (705.50), professional-fee (705.46), and government (705.47) standards, but comments on these standards are, or course, welcome.

a. *Retailers and wholesalers.* The most controversial aspect of the

percentage-gross-margin standard is the provision that allows companies whose percentage gross margins grew during the base period to continue their expansion at the same rate during the program period, but restricts companies whose margins were not growing to the base-year percentage.

Allowing the percentage gross margin to increase has been criticized by some. The Council adopted this policy because equal deceleration in the rate of growth of *dollar* gross margin per unit of output and in the prices of goods purchased for resale implies no change in the rate of growth of the percentage gross margin. Had all companies under this standard been restricted to a constant percentage gross margins, the allowable margin during the first year would have been 25.59 percent, 0.49 percentage point below the actual allowable.

Some retailers and wholesalers, on the other hand, argue that compliance units with zero or negative margin trends should be allowed a minimum positive trend—e.g., an allowable increase of one percentage point. Such a positive floor for the percentage-gross-margin trend has been likened to the 5-percent floor for the allowable two-year price limitation. The analogy is not apt, however, because constancy of the *percentage* gross margin entails a positive growth in *dollar* gross margin per unit (and in prices charged) so long as the prices of goods purchased for resale are going up.

The Price Advisory Committee has suggested that the Council allow a company to choose between (1) continuing to project a positive margin trend or (2) having a dollar-for-dollar passthrough of the amount by which its program-year interest costs exceed its base-year interest costs. This suggestion was prompted by concern that the explosion in interest rates in late 1979 and early 1980 has a particularly profound effect on compliance units subject to the percentage-gross-margin standard. As noted above, the current decline in interest costs should make this less of a problem in the third program year. Nevertheless, the Council invites comment on the issue. Commentators should take note of the fact that the provision of alternatives necessarily introduces additional slippage into the standards, because companies inevitably select the one that allows them the greater price increases.

A separate question that has been raised is whether the Council should specify all of the items to be excluded in calculating gross margin. Currently, under the percentage-gross-margin standard, the retailer/wholesaler gross margin is defined as net sales less the cost of goods sold. Some firms apparently include within the cost of goods sold certain items, such as warehousing and transportation costs, that others do not. Although consistency is desirable, there are so many accounting variations among companies and among industries that the Council could not conceivably specify with the precision desired the elements of costs to be excluded in calculating gross margin. We, therefore, solicit suggestions for other alternatives.

b. *Food manufacturers and processors.* Some food processors and manufacturers have repeatedly asked to have the cost of other items besides the food used in their operations excluded in calculating their gross margin. The alternative gross-margin standard was provided to these companies, however, because of the volatility of farm prices; that is why only the cost of food products used in food manufacturing and processing is excluded in the calculation of gross margin. The processors argue that there are several other elements of uncontrollable costs that are sharply rising and should therefore be passed through; they point specifically to packaging, interest, and energy.

The Council has provided special gross-margin standards to some industries so as to avoid the full cost-passthrough provisions of the profit limitation. The more items that are excluded from the gross margin, the less incentive there is for companies to substitute inputs whose prices are going up more slowly for those whose prices are going up more rapidly—the more, that is, the gross-margin standard takes on more of the infirmities of a profit limitation. Moreover, the profit limitation is available to individual food processors (as well as other companies) that experience particularly large and uncontrollable cost increases.

To the extent that rapidly rising costs of items not excluded under the gross-margin standard are a major problem, an alternative to excluding these specific items from the gross margin would be to raise the allowable growth of the gross margin. This might provide the requested relief, while avoiding the cost-plus character of the other proposed remedy. The Price Advisory Committee has recommended that the Council seek from the industry documentation of the extent of the problem.

c. *Petroleum refiners.* We developed a gross-margin standard for petroleum refiners for the same reason as for food processors and manufacturers: their raw-material costs are large and highly volatile. Unlike the other standards, however, we reviewed and substantially modified this one after the beginning of the second program year. At that time, we required refiners to disaggregate refining and marketing operations from all other operations for purposes of compliance. In addition, we tightened the standard by (1) expressing the limitation in terms of the gross margin per barrel, which has the effect of lowering allowable dollar gross margins if volumes decline, (2) making the output-mix adjustment mandatory, which eliminates an option, and thereby cuts down slippage, (3) specifying more clearly that only the cost of goods sold may be deducted from revenues in computing the gross margin (that is, costs of crude oil and refined product placed in inventory must not be subtracted from revenues in this calculation), and (4) making the intermediate (quarterly) limitations more restrictive than the end-quarter (two-year) limitation. Finally, we stipulated that, effective January 1, 1980, the cost of process fuel used in refinery operations should be subtracted from revenue in calculating gross margins.

This review and modification resolved many of the questions that had arisen during the first program year and that were analyzed in the Council's report, *Petroleum Prices and the Price Standards,* released February 25, 1980. Nevertheless, several important issues remain, particularly with respect to the relationship between the petroleum-refiner standards and national energy objectives. In a report released on May 30, 1980, *The Council's Petroleum-Refiner Standards,* we concluded that the standards strike a reasonable balance between energy goals and restraining inflation, but pledged to continue to review outstanding issues and to develop policy options for the third program year. The two principal areas of concern are (1) investment and energy-conservation incentives and (2) the choice between a quarterly and an annual gross-margin standard.

(1) *Investment and Energy-Conservation Incentives.* It has been asserted that, by limiting gross margins (which include capital and other non-petroleum costs), the petroleum-refiner standard inhibits incentives to invest in expanded or upgraded refinery facilities (e.g., facilities that produce the same or a lighter mix of products with heavier or sourer crude oil), and that, more generally, it may discourage investments or processes that entail costs that have to be recovered in the gross margin. Of course, constraining price increases *always* runs the risk of inhibiting investment incentives, and *any* partial

cost-passthrough standard creates incentives to favor the use of inputs whose costs are passed through. There has been no documentation, however, that the gross-margin standard has significantly curtailed investment expenditures or unduly interfered with energy conservation efforts. This may be because of the availability of input- and output-mix adjustments of refiner margins, which at least partially compensate for changes in non-petroleum costs (including capital costs) associated with changes in the mix of inputs or outputs. Nonetheless, we recognize that possible interference with investment incentives and energy-conservation efforts would become more serious the longer the voluntary standards remain in place. Consequently, we are requesting public comment on the following possible revisions to the petroleum-refiner standard.

Alternative mix adjustment. With the mix adjustments required under the current gross-margin standard, the base-period margin is calculated using the program-quarter (current) proportions of input and output quantities. This procedure compensates refiners for mix-induced changes in non-petroleum costs (including capital costs)—that is to say, it gives them credit for shifts to less costly crude-oil inputs and to more valuable outputs—to the extent that the base-period price differentials reflect current cost differentials. It has been suggested, however, that this last condition is not being met, and, as a result, that the refiners' standard discourages investments that would enable refiners to adjust to a relative decline in lighter crude supplies and a relative increase in the demand for lighter products.

An alternative procedure that would correct for these deficiencies—to the extent they exist—would be to calculate the program-period gross margin using base-period quantities, rather than adjusting the base-period margin using current quantities. The program-period gross margin would thus be the difference between (1) revenues that would have been earned (at current product prices) on the mix of products sold during the base period and (2) the input costs that would have been incurred (at current input prices on the mix of inputs used during the base period. Any increases in actual revenues attributable to a change in the mix of sales toward higher-valued products would thus not appear in the constructed (mix-adjusted) revenues. Similarly, any decrease in costs attributable to a change in the mix of inputs toward lower-valued ones would not appear in the constructed (mix-adjusted) costs, and therefore the resultant savings would not show up in the constructed program-period gross margin. In other words, refiners would retain the benefits of investments, conservation efforts, or other measures that improve the productivity of refining operations—i.e., that produce higher-valued products from lower-costs inputs. (See Appendix B for a numerical example that compares these two procedures.)

To the extent that this alternative procedure encourages investment more than the current procedure does, the resultant increase in refinery productivity would tend to compensate for the reduced price restraint. To the extent that it merely provides windfall gains for investments that have already been made or that would take place in any event, there would be no offsetting advantage. One way to help ensure the former result would be for us to commit now to use such a procedure only in later program years (if any), when investments being considered now would be coming on line.

Mix adjustments with an updated base period. Any mix-adjustment procedure necessarily entails the use of the same quantities in computing the base- and program-period gross margins. The alternative mix adjustment described above holds quantities constant at their *base-period* levels, so as to eliminate inadequacies in the adjustment attributable to obsolescence of the relative base-period prices of different kinds of crudes and products. (When quantities are held constant at *current-period* levels, the mix adjustment uses *base-period* prices, because in this event it is the base-period gross margin that is a constructed rather than an actual one. Conversely, when quantities are held constant at *base-period* levels, the mix adjustment uses *current-period* prices, because the current-period gross margin is the one that is constructed—not actual.)

Under either the current or the alternative mix adjustment procedure, a related issue is whether the base period should be updated periodically. Under the alternative mix adjustment, this would have the effect of updating the quantities used in the mix adjustment. Under the current mix adjustment, this would have the effect of updating the prices used in the mix adjustment.

Under either method, whether updating the base would permit greater price increases depends on changes in relative prices and relative quantities. Individual refiners, of course, might be disadvantaged by the selection of a new base period, just as they may have been disadvantaged by the choice of the original base period. In either case, however, exceptions may be available for companies whose compliance is measured against an unrepresentative base.

Volume decreases. The alternative mix-adjustment procedure described above is designed to encourage improvements in productivity. A separate, but related, issue is whether allowable dollar gross margins should change as volume changes (which in many cases results in productivity changes). In the first program year, we permitted refiners to increase their dollar gross margin to reflect increases in volume. In the second program year, we extended this principle to volume declines, by expressing the limitation in terms of the gross margin per barrel.

Some refiners have argued that, since fixed costs (which constitute most of the gross margin) do not decrease with decreases in volume, the per-barrel calculation unduly restricts their profits. By the same token, of course, the standard rewards productivity increases that arise when volumes increase. Absent a compelling reason to the contrary—which we have not yet seen—we will probably conclude that the objectives of the anti-inflation program are best served by symmetric treatment of changes in volume.

(2) *Quarterly versus Annual Standard.* In the first program year, the refiners' gross-margin standard compared program quarters with a base quarter. In developing the second-year standard, we proposed instead that the "base-quarter gross margin" be the average quarterly gross margin in the base year. On the basis of public comments, we reverted to the base-quarter measure used during the first year.

It is now being suggested that the Council should move to an annual standard for the program year. Some refiners have argued that, with a quarterly standard, the timing of crude-oil and product acquisitions takes on undue importance because the acquisition costs in each quarter affect the allowable prices that can be charged only in that quarter. This may occur even if the acquisitions are placed in inventory, because under customary accounting practices transitory changes in crude-oil and product inventories can affect costs of goods sold. Accordingly, the refiners conclude, a quarterly standard may thwart inventory accumulation objectives or encourage perverse pricing patterns. A quarterly standard also raises problems when there are retroactive crude-oil price increases (like the ones we experienced

last winter) and when firms make annual, but not quarterly, inventory-valuation adjustments.

If we were to adopt an annual program-year gross-margin limitation, we would also consider making the base-period an annual, rather than a quarterly, measure. Conversion to an annual standard would also reduce the likelihood of unrepresentative base-period margins.

d. *Electric, gas and water utilities.* When the standards program was first announced, there was much thought given to excluding rate-regulated public utilities because utility prices are already regulated by various state and local public utility commissions (PUCs) as well as by several Federal agencies. On the other hand, prices charged by some utilities (e.g., power and gas) had recently increased substantially and it was thought that exclusion of such a prominent part of the economy would be undesirable in view of the economy-wide nature and urgency of the inflation problem. Our solution was to recognize the primary role of the State and local PUCs by asking them to administer our standards, while also delegating to them the responsiblility for granting exceptions. This division of labor was intended to minimize the administrative costs of the standards program for utility companies and, at the same time, to ensure that the objectives of the President's anti-inflation program would be considered by the PUCs in their deliberations.

During the past year, there has been renewed interest in excepting utilities from the standards program. It has been argued that the standards are at best duplicative and at worst inconsistent with the approaches and/or criteria used by PUCs in evaluating rate-increase requests. Public comment on this threshold question would be very useful.

Assuming that a standard for utility companies will be a part of the third-year program, we should consider whether it should be modified to make it more compatible with the regulatory practices of the PUCs. A relatively minor change would be to allow utilities the option of using either the Council's base and program years or the test year used by the PUCs. Those who choose the latter would not have the additional computation costs required to demonstrate compliance with the Council's standard. On the other hand, the transition to a different program period would itself raise administrative and computational problems. In addition, allowing companies a choice between alternatives introduces additional slippage in the standards.

A more substantial endeavor would be to recast the standard to coincide more closely with the standards typically used by PUCs. This was the spirit of the Council's recent revision of the gross-margin standard for electric and gas utilities, permitting them either to include in the base-year margin the allowance for funds used during construction of plant not yet in service, or to exclude from the program-year margin a part of the additional revenue requirements attributable to the entry of new plant in service or construction work in process into the rate base.

The ultimate revision would be for the Council simply to defer to the PUCs, not merely in the administration of its standards, as it present, but also in the standards to be applied. The purpose of this change, as of those already made, would not be to weaken price restraint on utility companies, but only to recognize that PUC's already have the legal responsiblity to restrain rate increases in the public interest, and that the superimposition of the Council's standards could be either redundant or a kind of double regulation to which no other industries are subject.

The fact remains, however, that, to the extent that the Council's standards have an additional constraining influence, removing them would constitute a relaxation of the standards. We invite comments on these possibilities.

10. *Company Organization.* At the beginning of the first program year, firms were given considerable latitude (subject to certain accounting restrictions) in organizing themselves for compliance purposes; some chose to report to the Council as one integrated unit, and others disaggregated themselves into separate compliance units. We afforded such latitude largely to hold down companies' compliance costs and to accommodate firms with operations in several different sectors of the economy that are subject to vastly different economic forces.

At the beginning of the second program year, we allowed companies to reorganize themselves for compliance purposes, thus allowing them to respond to internal changes, altered economic circumstances, and simple mistakes in choosing compliance structures. We recognized that this would permit firms to group different portions of their operations in ways that allowed access to various exceptions. While this freedom created some slippage in the price standards, we believed the amount involved would probably not be significant, particularly since we did not generally permit reorganization during the program year.

We must now confront the question of whether firms should again be permitted complete latitude (subject to certain accounting criteria) to reorganize for the third program year. The pros and cons have not changed from last year. Accordingly, at this time we are leaning toward permitting such reorganization between program years, but not allowing reorganization within the year.

Assuming that company reorganization is permitted between the second and third program years, we are considering (at the suggestion of some) whether to *require* some disaggregation for compliance purposes in the third year. The ability of highly diverse firms to report as a single unit has made it difficult for the Council to obtain industry-specific data from major producers in industries exhibiting high inflation rates and to monitor effectively and equitably different companies operating in the same industry. Equally important, the flexibility in company organization has created inequities among companies in their access to modified price standards and in their ability to comply with the price standards. An example of the first situation is that a company with 50 percent or more of its revenues derived from food manufacturing or processing may report all of its operations under the food-processing gross-margin standard, while a company with 49 percent of its revenues derived from these activities would have to disaggregate in order to place its food-processing operations under that standard. An example of the second (and more serious) type of inequity arises from the fact that a comglomerate reporting on a consolidated basis might be able to offset high price increases in one area of its operations with low price increases in another; as a result it might be able to comply more easily than a company that operates only in the industry with large price increases.

Nonetheless, specifying ways for companies to disaggregate for compliance purposes has several problems. Obviously, it reduces their discretion to adopt the organizational structure they consider most suitable. It might disrupt their established frameworks for managing their business activities, or impose additional reporting burdens. It also would be difficult to specify the types of acceptable or unacceptable disaggregations. Most important, it would reduce the flexibility to adjust relative prices in response to changing market conditions—a feature of the price standard that promotes economic efficiency.

On approach would be to require disaggregation (as long as the accounting criteria are met) to the level of the major economic sectors as defined in the Standard Industrial Classification Code (e.g., agricultural production; mining; construction; manufacturing; transportation, communication, and utilities; wholesale/retail trade; finance, insurance, and real estate; and services). Another possibility would be to require a company applying a modified price standard to disaggregate the affected segment of its operations as a separate compliance unit. Finally, we could approach this problem on a case-by-case basis by placing suitable organizational-structure restrictions on grants of exception.

The flexibility accorded to companies in organizing for compliance purposes also can be used to shield the parent company from the adverse publicity of a noncompliance action against one of its compliance units. To increase the incentives for compliance, the Council is considering listing the parent as well as the particular compliance unit.

The Council solicits public comment on all of these issues of company organization.

11. *Self-Administration of Uncontrollable-Cost Exceptions.* The great majority of exception requests during the first two years have been based on uncontrollable cost increases. This is an area where the Council has over time refined the criteria both for eligibility and for the documentation needed to demonstrate it. In fact, by the time we promulgated the second-year price standards, these criteria were so well developed that they could have been incorporated directly into the standards. If that had been done, it would have had the effect of authorizing companies that satisfied the eligibility criteria to self-administer the exception, just as companies eligible for some of the modified standards for selected industries are able to choose them.

Not only has the Council had two years of experience with administering this exception, but the companies as well have undoubtedly developed a good understanding of the Council's approach to these cases. This is evidenced by the fact that most requests for this exception are now routinely approved, although there are still a signficant number of cases where insufficient data are provided.

Because of these developments and because we maintain an interest in reducing compliance burdens, we are considering allowing companies to self-administer uncontrollable-cost exceptions during the third program year. One disadvantage would be the greater likelihood that companies would self-administer exceptions to which they were not entitled, although this danger could be minimized by requiring companies to notify the Council when they self-administer the exception and to submit supporting documentation. An intermediate approach would be to permit self-administration of uncontrollable-cost exceptions only by companies that had already received Council approval during the second program year, on the ground that they are likely to be eligible, and presumably are relatively familiar with the technical questions involved.

12. *Price Prenotification.* We assess compliance with the standards after price increases have been put into effect. Price increases that exceed the standards come to our attention mainly when companies file their quarterly compliance reports. We might, however, improve the program's effectiveness if we assessed compliance before price increases took place, because companies typically are more willing to modify prospective increases than to take after-the-fact corrective action—which may involve price rollbacks. In addition, if we asked companies to notify us before they increased prices, it would facilitate rapid resolution of possible misunderstandings or misinterpretations of the standards and encourage companies to maintain a closer and more current check on their compliance posture.

Such considerations provided the rationale for the price prenotification program that the President announced on March 14. Because it is so late in the second program year, the Council will not initiate a prenotification program this year, and is using this *Issue Paper* to solicit comments on whether there should be a program for the third year and, if so, what it should look like.

The program that the Council is considering would be selective and voluntary, seeking prenotification only where the benefits in improved price restraint clearly outweigh the heavier reporting burdens. Prenotification would not be used to delay or to suspend proposed price increases, as it was in the Nixon Administration's Economic Stabilization Program; the Council does not have statutory suspend-and-delay authority and will not seek it. To the extent that the Council's intentions are misunderstood, a prenotification plan may lead to anticipating price increases that will diminish any benefits of the effort.

The number of companies asked to prenotify would be kept small to limit the reporting burden and to assure timely Council responses. Possible criteria for selection are (1) problem sectors, (2) basic or key industries, (3) company size, (4) price leadership, (5) degree of industry concentration, (6) historical industry pricing practices, and (7) homogeneity of product lines.

To help develop a prenotification program, the Council has consulted a number of outside groups; these have raised a number of problems with which we are still grappling. First, because businesses often do not know the exact size of a price increase until shortly—days or even hours—before the increase is implemented; therefore, it could be hard to prenotify with sufficient lead time. Second, because of differences in company pricing policies, different lead times would be appropriate for different companies; even pricing within a company can vary from region to region and product to product. Third, because data for prenotification are not kept in the ordinary course of business, projecting compliance would involve additional administrative cost. Because of the difficulties involved in developing a workable prenotification program, the Council strongly urges comments on this issue.

Appendix A. Detailed Analysis of Company-Specific Pay Data

This appendix provides more detailed breakdowns of the company-specific pay data issued in Section II–B.

In Table A–I, we provide the base-period and program-period data that were used in calculating the unadjusted and adjusted pay-rate increases shown in Table 4. The pay-rate increases shown at the bottom of the table can be calculated by dividing the appropriate program-period level by its corresponding base-period amount in the upper half of the table.

The nature of the adjustments and exceptions for the program period that were used in calculating the overall statistics in Table A–I are shown in more detail in Table A–II. For each category, we present the percentage of workers who received the adjustments and, for those workers, the increase in the dollar adjustment over the comparable adjustment for the base period and, the percent of the workers' base year pay that these net adjustments represent. In addition, we show the magnitude and percentage amount that these adjustments represent on average for all workers, including those who received no adjustments (i.e., the weighted hourly adjustment).

Although the implications of the patterns were discussed earlier in the report, some additional explanation of the adjustment categories is helpful in interpreting the results.

Table A-I.—*PAY-1 Data Components of Hourly Pay*[1].

[In dollars]

	All workers[2]	Collective bargaining units[2]	Management units	Other units
Pay component:				
Number of base-period reporting workers	7,430,162	1,399,054	2,415,395	3,615,713
Percent of base-period reporting workers	100.0	18.8	32.5	48.7
Base Period (BP):				
BP unadjusted hourly pay rate	$11.34	$12.15	$14.44	$9.96
BP unadjusted wages and salaries	8.78	8.49	11.23	7.09
BP unadjusted hourly cost of incentive pay	0.42	0.13	0.77	0.26
BP unadjusted hourly cost of benefits	2.23	3.54	2.44	1.88
BP total adjustments	0.11	0.01	0.16	0.11
BP adjusted hourly pay rate	11.23	12.15	14.28	9.85

	First year	Annualized	First year	Annualized		
Program Period (PP):						
PP unadjusted hourly pay rate	12.30	12.15	13.51	13.24	15.40	9.55
PP unadjusted hourly wages and salaries	9.37	9.34	9.40	9.24	12.02	7.59
PP unadjusted hourly cost of incentive pay	0.41	0.41	0.14	0.13	0.77	0.25
PP unadjusted hourly cost of benefits	2.41	2.39	3.96	3.87	2.62	1.67
PP total adjustments	0.05	0.24	0.04	0.26	0.29	0.19
PP adjusted hourly pay rate	11.94	11.91	13.13	13.05	15.11	9.36
Unadjusted pay-rate increase (percent)	7.8	7.1	11.0	9.9	6.6	6.6
Adjusted pay-rate increase (percent)	6.3	6.1	7.5	5.6	5.8	5.4
Unadjusted minus adjusted increase (percent)	1.3	1.0	3.1	2.1	0.8	0.8

[1]The percentage increases are obtained by averaging across employee units, using base period employment as weights. Components may not add to total because of rounding.

[2]Pay increases for collective bargaining units are calculated in two ways: The first-year calculations represent the costs of the first year of collective-bargaining agreements, negotiated during the program period, while the annual-average data pertain to the (geometric) average annual rate of increase over the life of the contract. Because of front loading, first-year estimates for multi-year contracts are usually larger than the annual averages.

Table A-II.—*Program Period—PAY-1 Data Adjustments*[1]

Adjustment category	All workers	Collective bargaining units[2]	Management units	Other units
Total program-year adjustment:				
Percent of reporting workers affected	53.2	85.8	47.7	44.2
Hourly adjustment per affected employee:				
Dollars	0.23	0.31	0.27	0.18
Percent	2.0	2.5	1.9	1.9
Weighted hourly adjustment:				
Dollars	0.13	0.26	0.13	0.08
Percent	1.1	2.2	0.9	0.9
Incentive pay/sales commission overages attributable to higher volume:				
Percent of reporting workers affected	6.6	6.5	10.0	5.6
Hourly adjustment per affected employee:				
Dollars	0.05	0.01	0.06	0.06
Percent	0.7	1.3	0.4	0.7
Weighted hourly adjustment:				
Dollars	0.00	0.00	0.01	0.00
Percent	0.0	0.0	0.0	0.1
OOIA payment overages:				
Percent of reporting workers affected	22.3	74.0	6.1	13.6
Hourly adjustment per affected employee:				
Dollars	0.23	0.25	0.25	0.20
Percent	1.9	2.0	2.1	1.7
Weighted hourly adjustment:				
Dollars	0.05	0.18	0.02	0.03
Percent	0.5	1.5	0.1	0.3
Maintenance of health benefits overages:				
Percent of reporting workers affected	25.8	74.9	29.3	25.1
Hourly adjustment per affected employee:				
Dollars	0.04	0.04	0.04	0.03
Percent	0.4	0.3	0.3	0.4
Weighted hourly adjustment:				
Dollars	0.01	0.02	0.01	0.01
Percent	0.1	0.2	0.1	0.1

Table A–II.—*Program Period—PAY–1 Data Adjustments*[1]—Continued

Adjustment category	All workers	Collective bargaining units[2]	Management units	Other units
Overages due to nonchargeable changes in defined-benefit pension funding costs:				
Percent of reporting workers affected	17.3	63.5	8.6	8.0
Hourly adjustment per affected employee:				
Dollars	0.07	0.02	0.13	0.05
Percent	0.6	0.1	0.6	0.6
Weighted hourly adjustment:				
Dollars	0.01	0.01	0.01	0.00
Percent	0.1	0.1	0.1	0.0
Exclusion of unaltered pension plan:				
Percent of reporting workers affected	9.3	2.5	16.2	16.3
Hourly adjustment per affected employee:				
Dollars	0.10	0.26	0.09	0.05
Percent	1.2	3.7	0.7	0.6
Weighted hourly adjustment:				
Dollars	0.01	0.01	0.01	0.01
Percent	0.1	0.1	0.1	0.1
Exclusion of qualified profit-sharing retirement plans:				
Percent of reporting workers affected	5.5	0.1	8.6	8.9
Hourly adjustment per affected employee:				
Dollars	0.15	0.65	0.04	0.04
Percent	1.4	5.4	0.3	0.5
Weighted hourly adjustment:				
Dollars	0.00	0.00	0.00	0.00
Percent	0.0	0.0	0.0	0.0
Overages from formal annual pay plans:				
Percent of reporting workers affected	16.0	NA	29.7	14.3
Hourly adjustment per affected employee:				
Dollars	0.09	NA	0.10	0.08
Percent	0.6	NA	0.7	1.0
Weighted hourly adjustment:				
Dollars	0.01	NA	0.02	0.01
Percent	0.1	NA	0.2	0.1
Effect of fixed-pop. method; promotions:				
Percent of reporting workers affected	7.3	NA	11.7	4.3
Hourly adjustment per affected employee:				
Dollars	0.11	NA	0.17	0.07
Percent	1.2	NA	1.4	1.0
Weighted hourly adjustment:				
Dollars	0.01	NA	0.02	0.00
Percent	0.0	NA	0.1	0.0
Effect of fixed-pop. method; qualification increases:				
Percent of reporting workers affected	3.4	NA	4.2	2.9
Hourly adjustment per affected employee:				
Dollars	0.13	NA	0.12	0.13
Percent	1.3	NA	0.9	1.6
Weighted hourly adjustment:				
Dollars	0.00	NA	0.00	0.00
Percent	0.0	NA	0.0	0.0
Effect of weighted average method:				
Percent of reporting workers affected	2.2	NA	1.8	2.0
Hourly adjustment per affected employee:				
Dollars	0.14	NA	0.22	0.08
Percent	1.3	NA	1.7	1.0
Weighted hourly adjustment:				
Dollars	0.00	NA	0.00	0.00
Percent	0.0	NA	0.0	0.0
Overages from pay exceptions: OWPS approved				
Percent of reporting workers affected	8.7	13.8	4.4	8.3
Hourly adjustment per affected employee:				
Dollars	0.15	0.20	0.15	0.14
Percent	1.5	2.1	1.2	1.4
Weighted hourly adjustment:				
Dollars	0.01	0.03	0.01	0.00
Percent	0.1	0.2	0.1	0.1
Overages from pay exceptions, self administered:				
Percent of reporting workers affected	2.5	2.1	2.4	2.6
Hourly adjustment per affected employee:				
Dollars	0.13	0.31	0.13	0.06
Percent	1.0	1.8	0.9	0.8
Weighted hourly adjustment:				
Dollars	0.00	0.01	0.00	0.00
Percent	0.0	0.1	0.0	0.0

[1]The percentage increases are obtained by averaging across employee units, using base period employment as weights.
[2]Annualized over the life of contract.

Adjustments for incentive pay overages attributable to higher volume are provided in instances where physical volume increases can reasonably be attributed to increased work effort or improved worker performance. COLA payment overages reflect the costs attributable to the difference between the company's inflation assumption for costing out cost-of-living escalators and the stipulated assumption of a 6-percent inflation rate. The maintenance-of-health-benefits exclusion represents the costs above 7 percent involved in maintaining the present levels of health insurance coverage, which the Council excludes from consideration.

There are three retirement-plan adjustments. The first pertains to changes in defined pension funding costs—that is, changes in costs attributable to altered actuarial assumptions or poor performance of the fund's investments. The exclusion for unaltered pension plans pertains to pension plans that link benefits to the level of wages and salaries. In cases where the plans are not amended and the benefit structure remains unchanged, companies could exclude all pension costs from the base period and program-period pay rates. Finally, costs associated with profit-sharing retirement plans may be excluded from the pay calculations when the formulas are not changed.

The adjustments for formal annual pay plans exclude from the chargeable increases all pay increases above 7 percent that are made under pre-existing formal pay plans. Only previously communicated increases are included in this exclusion.

There are two types of adjustments pertaining to the method of computation used to detemine compliance. If the fixed-population method is used, pay increases resulting from promotions or qualification increases are excluded. If the unit-average method is used and the mix of workers changes from the base period, the pay increase calculations can be done using the base-period weights, with the difference in the results being excluded from the chargeable increases.

The final two adjustment categories are for exceptions granted by the

Council or self-administered by the company. The categories for both kinds of exceptions are identical: acute labor shortages, tandem relationships, gross inequity, or undue hardship, and productivity-improving work-rule changes.

The key pages of the Council's PAY–1 form in which the data in Tables A–I and A–II are based are reproduced as Table A–III. The blanks in the form have been completed using the average amounts for all of the reporting companies.

Finally, we have included in Attachment A–I a summary of the pay standards from the Council's *Compendium*. This discussion summarizes the factors guiding the design of the pay standard. Part 6 of this excerpt material provides a detailed description of the criteria for exceptions and exemptions from the pay standard.

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Table A-III

Part III - Pay Rate Data 1/

	(A) Base Period Pay Rate	(B) Program Period Pay Rate	
1. Straight-Time Wage and Salary:	$ 8.70	$ 9.34	1
(Projected COLA at__% CPI:$_._ _ _)			
2. Incentive Pay (where applicable):			
a. Sales commission and production incentive pay:	_ _._ _ _	_ _._ _ _	2a
b. Bonuses and other annual incentive pay:	_ _._ _ _	_ _._ _ _	2b
c. Long term incentive pay:	_ _._ _ _	_ _._ _ _	2c
d. Total hourly cost of incentive pay:	0.42	0.41	2d
3. Benefits:			
a. Pay for time not worked	_ _._ _ _	_ _._ _ _	3a
b. Savings and thrift plans:	_ _._ _ _	_ _._ _ _	3b
c. Qualified defined-benefit retirement plans:	_ _._ _ _	_ _._ _ _	3c
d. Health benefit plans:	_ _._ _ _	_ _._ _ _	3d
e. Other insurance plans:	_ _._ _ _	_ _._ _ _	3e
f. Other (total):_____ _____	_ _._ _ _	_ _._ _ _	3f
g. Total hourly cost of fringe benefits:	2.23	2.39	3g
4. Hourly Pay Rate (Sum of 1+2d+3g):	$ 11.34	$ 12.15	4
5. Annual Percent Pay-Rate Increase:	7.1 %		5

IF THE ANNUAL PERCENT PAY-RATE INCREASE IS 7 PERCENT OR LESS (AND FOR MULTI-YEAR AGREEMENTS, NO INDIVIDUAL YEARLY INCREASE IS ABOVE 8 PERCENT) AND DEFINED-BENEFIT PENSION FUNDING COSTS ARE UNCHANGED, THE EMPLOYEE UNIT IS IN COMPLIANCE AND ITEMS 6-8 NEED NOT BE COMPLETED.

1/ Components may not add to total because of rounding.

	(A) Base Period Pay Rate	(B) Program Period Pay Rate	
6. Adjustments to pay rate (where applicable)			
a. Alternate base adjustment for bonus plans:	-$ 0.0 0		6a
b. Sales commission/production incentive pay due to higher volume:		$ 0.0 1	6b
c. COLA payments beyond 6 percent increase in CPI (attach copy of formula):		0.0 5	6c
d. Maintenance of health benefits cost increase above 7 percent:		0.0 1	6d
e. (1) Non-chargeable changes in defined-benefit pension funding costs:		0.0 1	6e(1)
(2) Exclusion of unaltered pension plan:	0.0 9	0.1 0	6e(2)
f. Exclusion of qualified profit-sharing retirement plan:	0.0 2	0.0 2	6f
g. Overage from formal annual pay plans:		0.0 1	6g
h. Overage from pay exceptions			
(1) Approved by CWPS (TA__ LS__ WR__ WH__):		0.0 1	6h(1)
(2) Self-Administered(TA__ LS__ WR__ WH__):		0.0 0	6h(2)
i. Effect on average wage if fixed population method used, 705B-4(b)			
(1) Promotions (in base period $_ _._ _ _):		0.0 1	6i(1)
(2) Qualification increases (in base period $_ _._ _ _):		0.0 0	6i(2)
j. Effect on pay rate if weighted average method used, 705B-4(e):		0.0 0	6j
k. Total adjustments:	$ - 0 . 1 1	$ 0.2 4	6k
7. Adjusted Hourly Pay Rate (Difference 4-6k):	$11.23	$11.91	7
8. Adjusted Annual Percent Pay-Rate Increase:	6.1 %		

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Attachment A–I

Excerpts From Pay and Price Standards: A Compendium

Part I: Design of the Pay/Price Standards

The pay and price standards have been crafted carefully to strike a balance among four principal criteria: effectiveness, simplicity, equity, and economic efficiency.

To be effective, the goals of the standards were targeted to be ambitious enough for widespread compliance to reduce inflation significantly without being so ambitious that compliance becomes impractical. Also for effectiveness, the standards were designed to apply to a wide range of diverse economic activities.

Against the need for widespread coverage, every effort has been made to retain simplicity. And, in fact, the basic standards remain simple for most businesses to apply. However, some increased complexity has come about in response to requests from large businesses for more specificity and due to the need to provide modifications that account for the institutional characteristics and operational realities of certain industries.

For purposes of equity, the standards request moderate restraint from the widest possible range of individuals and organizations; no one group is asked to shoulder a disproportionate share of the burden. But, as in any effort to break into a pay/price spiral, some are bound to be affected sooner or to a somewhat greater degree than others. In recognition of this fact, the standards include several explicit provisions aimed at avoiding the imposition of major inequities.

As with most government intervention in the marketplace, the call for restraint in pay and price decisions runs the risk of inducing some economic inefficiencies by distorting market incentives and signals, resulting in a misallocation of resources. This concern is reflected throughout the standards, evidenced by the general focus on *average* prices and pay rates rather than on those of *individual* products and workers, thus allowing relative prices and pay rates to respond to market conditions.

In designing and revising the standards, adherence to these criteria forced numerous difficult decisions required to balance conflicting objectives. In particular, most efforts to add sensible exception provisions and to provide the degree of flexibility needed to minimize potential inequities and market distortions directly reduced the potential effectiveness of the standards. Conversely, most efforts to increase potential effectiveness increased the risk that compliance would cause inequities and inefficiencies.

Since the standards are sufficiently ambitious to be effective with widespread compliance, it is undoubtedly the case that some inequities and inefficiencies will result. But, these are likely to be small compared to the capricious inequities and the fundamental economic inefficiencies caused by inflation itself.

The pay and price standards were designed to be consistent with each other, assuming a continuation of the well-established historical relationship between prices and unit labor costs.

The price deceleration standard provides each firm with its own numerical limitation on price increases during the program year. For each firm, this limitation is derived by deducting one-half of a percentage point from the average annual rate of price increase over the 1976–77 period. If every company in the U.S. economy were to adhere precisely to this standard, the program-year inflation rate would be about 5¾ percent. This figure is obtained by deducting one-half of a percentage point from the 6¼ percent annual rate of increase in the Consumer Price Index, excluding food, during the 1976–77 period.

However, not all firms will be able to achieve price deceleration, due to raw-material price increases, previously negotiated labor contracts, and other factors. To comply with the price standard, these firms will resort to the profit-margin exception, which allows unit-cost increases to be passed through on a percentage basis up to 6½ percent and on a dollar-for-dollar basis thereafter. Given full compliance with the price standard, including this exception, inflation would be about 6½ percent in absence of raw-material shortages or external supply shocks.

The standards were designed to make this price objective consistent with full compliance with the pay standard, constant functional income shares (i.e., constant profit margins and a constant labor share of total national income), and the estimated long-term productivity trend.

The pay standard requests that average increases in wage rates and private fringe-benefit costs per hour not exceed 7 percent over the program year. However, with full compliance, actual private hourly compensation costs will rise by about 7¾ percent. The slippage between the 7-percent pay standard and the 7¾ percent objective is attributable to several provisions and exceptions included to accommodate legitimate concerns about equity and economic efficiency. When mandated Social-Security cost increases above 7¾ percent are included, total compensation per hour will increase by about 8¼ percent. Deducting from this figure the 10-year productivity growth trend of 1¾ percent, unit labor costs will increase by about 6½ percent.

Historically, changes in unit labor costs and changes in prices have been very closely related, reflecting the virtual constancy of functional income shares. The numerical standards were designed purposely to reflect this relationship. Hence, as seen above, the 6½ percent increase in unit labor costs, assuming full compliance with the pay standard, is consistent with the 6½ percent price objective, assuming full compliance with the price standard.

This is not a forecast of inflation rates over the program year. Even with full compliance, if productivity growth rates are below historical averages or if there are major perverse supply shocks, price increases will exceed the above objective.

The pay and price objective for the second program year will, of course, depend on the degree of success during the first year. Therefore the second-year standards will not be formulated until the third quarter of 1979.

A. The Pay Standard

Compliance with the pay standard requires that pay rates increase by 7 percent or less for each of several identified employee groups. The 7-percent standard is not intended as a target for pay-rate increases; it is an upper limit, or cap. Where market forces suggest that smaller increases are warranted, smaller increases should be granted.

The standard imposes a common numerical limit across industries and regions. Although an assumption about *aggregate* productivity growth provides the link between the pay standard and price standard, the pay standard does not vary across industries or firms depending on industry-specific or firm-specific productivity changes. The absence of such productivity adjustment reflects both the effectiveness and equity criteria discussed above.

First, productivity is extremely difficult to measure and the existence of a general adjustment would create a significant loophole, preventing the effective limitation of pay-rate increases.

More importantly, from an equity standpoint, the disparities between productivity growth rates across industries are not attributable to differences in the diligence of the workers involved; instead they are due to the fact that there is more potential for productivity-improving innovations in some industries (for example, manufacturing) than in others (for example, services). Further, there is no logical justification or historical support for the notion that high-productivity-growth industries are high-wage-growth industries. Instead, disparities in productivity growth rates across industries tend to be reflected in divergent price trends; price increases tend to be relatively low in high-productivity-growth sectors and relatively high in low-productivity-growth sectors.

Although the notion of a pay standard tied to company-specific productivity growth has been rejected in the interest of promoting efficiency, incentive pay plans that relate individual pay rates to individual performance receive special treatment.

Incorporation of the above criteria (effectiveness, simplicity, equity, and efficiency) dictate several other general characteristics of the pay standard:

- For reasons of equity and effectiveness, *all* forms of pay are included.
- The standard applies to the sum of different types of pay rather than to each component separately, imposing no restrictions on the mix of pay increases.
- The standard applies the average pay rates for employee groups rather than for individual employees, imposing no restrictions on the distribution of pay-rate increases across individuals.
- The standard applies directly to those components of pay that firms control, and makes certain allowances for pay increases not controlled directly by the company.

1. Components of Pay

Pay rates are defined to exclude overtime pay unless the terms of the overtime pay are changed (say by changing the formula from time and a half to double time, in which case the impact on hourly cost should be estimated and counted as a pay increase).

Private fringe-benefit payments—but not employer contributions to legally-mandated benefit programs such as Social Security, unemployment insurance, and workers compensation—are counted as pay. These private fringe benefits include (but are not confined to) pensions, health insurance, and all forms of paid leave.

The inclusion of fringe-benefit costs is important since these have become an increasingly significant component of labor costs in recent years, and their inclusion is necessary to avoid an obvious loophole: the substitution of fringe benefits for cash wages. However, the standard allows complete flexibility between wage increases and benefit improvements. For example, if the base pay rate for an employee group averages $8.00 per hour in wages with an additional $2.00 per hour in benefits, the total wage and benefit base is $10.00 per hour. Under the standard, the average increase cannot exceed 7 percent annually, or 70 cents per hour. This allowable 70-cent increment can be distributed in any manner between wage increases and benefit improvements.

There are three important qualifications to the provision that all increases in costs of benefits are counted against the standard. First, government-mandated increases—including increases in items mentioned earlier—are excluded from the calculation of pay increases, since these cost increases are beyond the control of the employer.

Second, only the first 7 percent of the increased cost of *maintaining* existing health-plan benefits is counted. It could be argued that the entire increased cost of maintenance of benefits (MOB) should be counted against the standard because (1) these increased costs add to labor costs and exert upward pressure on prices, and (2) not counting the increased cost of MOB discriminates against workers whose employers do not provide elaborate fringe-benefit plans and must therefore pay their own increased medical-care costs out of their increases in wages (which do count against the standard). On the other hand, the equity issue results in a standoff because, without the special provision for this category of fringe benefits, employees with identical benefit packages could be subject to different limitations on wages and salaries due to differences in benefit plan experience or in the timing of premium adjustments. In addition, employers object to including all increases in MOB costs because they have little or no control over them. It was this latter point that led the Council to revise the treatment of maintenance of medical-care costs in the final standards.

Third, for the same reasons, increased costs of maintaining a pension fund, with no improvement in benefits, are not counted against the pay standard. Such cost changes can come about because of changes in funding methods, changes in amortization periods, changes in actuarial assumptions, or plan experiences.

The full amount of all cost increases due to *improvements* in health or pension benefits is counted in determining pay-rate changes.

2. Employee Groups

The 7-percent limitation on annual pay-rate increases does not apply to individual employees. Instead, the standard applies to the *average* pay-rate increases for units of employees. Within each unit, some employees may receive increases above 7 percent so long as these excesses are offset by smaller increases for other employees in the same unit. This flexibility allows employers to adjust individual pay rates on the basis of individual merit and market conditions for different types of labor services, so long as the overall 7-percent limitation is satisfied. This feature of the pay standard promotes economic efficiency and facilitates equitable pay policies.

The separate employee units to be identified under the standard are (1) each collective bargaining unit, (2) all management personnel, and (3) nonmanagement employees not covered by collective bargaining agreements. A collective bargaining unit representing less than 5 percent of all employees in a firm need not be considered separately, but can be combined with the appropriate nonunion group. Any reasonable divisions of the nonunion employees into management and nonmanagement units is acceptable.

Collective bargaining units are required to be identified separately because these employee groups are subject to binding contracts and the contract terms can be altered only at the time of negotiation. The standards therefore apply to the terms of newly negotiated contracts. For nonunion employees, the distinction between management and nonmanagement groups is provided to ensure that management decisions about pay-rate increases provide equitable treatment for nonmanagement employees. If a company can provide an alternative means of demonstrating that this equity condition is satisfied, the two groups may be combined.

3. Application of the Pay Standards to Collective Bargaining Agreements

The pay standard does not apply to existing contractual agreements reached before announcement of the program. Instead, it requires that the annual rate of increase of pay rates dictated by any *new* collective bargaining agreement (any agreement entered into during the program year) be no greater than 7 percent compounded over the contract term. Since these increases are compounded, pay rates can increase by approximately 14¼ percent over the live of a two-year agreement and 22½ percent over the life of a three-year agreement. Under such multi-year agreements, however, the total allowable increase must be allocated fairly evenly over the life of the contract—no more than 8 percent of the total allowable increase can occur in any single year of such an agreement. This allows for some "front loading," a common characteristic of labor contracts.

A large and increasing number of collective bargaining agreements have built-in escalators, or cost-of-living adjustments. The actual pay-rate increases generated under these contracts will depend on the actual rates of inflation experienced over the contract term. In order to provide a method by which the parties can determine whether a new contract complies with the standard at the time it is signed, cost-of-living adjustments in multi-year contracts are to be evaluated assuming a 6-percent annual inflation rate. This rate is below the anticipated inflation rate for 1979, even assuming full compliance with the pay and price standards, but is a reasonable assumption to make for the period covered by multi-year contracts. For this reason, the 6-percent assumption cannot be employed in labor contracts covering one year or less. One-year contracts with cost-of-living adjustment clauses must be evaluated retrospectively, using the *actual* inflation rate and hence the actual cost to the employer.

4. Application of the Pay Standard to Nonunion Employee Units

For employee units not covered by collective bargaining agreements, the standard requires that average pay rates in the final quarter of the program year be no more than 7 percent greater than the average pay rates in the base quarter. The base quarter is the last complete fiscal or calendar quarter prior to October 2, 1978, and the terminal quarter is the corresponding quarter of 1979.

In many cases, actual pay-rate increases during the coming year will be based on decisions and commitments made prior to the announcement of the program. In order to provide equitable treatment of union and nonunion units, recognition of these situations is necessary. As a result, when pay-rate increases are dictated by the continuation of a formal, documented annual wage and salary program already in operation, the completion of this program is allowed. Similarly, if future pay-rate increases have already been promised or communicated to the recipient employees, these promised increases are allowed. Compliance requires, however, that new pay plans announced during the program year be consistent with the 7-percent standard for the next planning year of the company.

Changes in average pay rates are determined by changes in the pay rates of individual employees and by changes in the composition of the employee group. In some cases, the 7-percent standard would be exceeded solely due to a shift in the composition of employment toward individuals with higher skill levels and, therefore, higher pay rates. To prevent such situations, two methods are provided for neutralizing the effects of skill-mix changes on average pay rates for nonunion groups. The first allows pay-rate increases to be computed as a weighted average of the separate increases for distinct employee subgroups within an employee unit. This is similar to the procedure used in determining the pay-rate increase over the life of a new collective bargaining agreement. The second method allows the computation of pay-rate changes for the group of continuing individuals employed throughout the program year. Using this latter method, pay-rate increases for legitimate, individual promotions and changes in individual job qualifications may be excluded. Under this option, a company that gives company-wide raises (including benefits) of 7 percent and

continues its normal promotional practices will be in compliance with the standard regardless of changes in the employee skill mix during the program year. This approach should be especially useful to small firms that do not typically perform extensive cost-control budgeting analyses.

5. Variable Compensation

Application of the pay standard to nonunion employee groups is complicated by the existence of widely varying, and often complicated, incentive pay plans. Typically, the actual payments received by employees under these plans are not controlled by the firm once these plans are in place. In fact, the primary rationale for these plans is that pay should be high when individual or company performance is good and low when it is not. The primary examples are commission programs, piece-work pay, annual bonus plans, and long-term incentive plans.

Two principles guide the treatment of these programs under the pay standard: (1) all such forms of compensation should be counted as pay and (2) such compensation should be counted as pay when earned rather than when paid (except for discretionary bonuses). Commission and piece-work pay increases in excess of 7 percent under these plans will not put a company out of compliance if it can be shown that the extra pay is attributable to increases in physical volume rather than to rising prices or a change in the pay formula. As noted above, *discretionary* bonuses are counted as pay when received. *Nondiscretionary* bonuses (i.e., bonuses dictated by a fixed formula or rule) are counted as pay when earned. In dealing with incentive pay that is tied to profit, companies should make a projection of the growth in profit and grant salary increases that are consistent with the profit projection and the pay standard. Pay increases that exceed 7 percent because profits rise by more than was reasonably expected will not result in determinations of noncompliance.

"Future-value incentive programs," such as stock option plans (providing the option to purchase stocks at some future date at a currently stipulated price) are treated separately. Under this type of plan, compensation received by exercising a purchase option during the program year will be the result of grants or commitments made before the announcement of the anti-inflation program, and is not charged against the pay standard. Similarly, the compensation value of grants made during the coming year will not be known until several years in the future. In these cases, the 7-percent limitation is applied to the *number of units granted* (per eligible employee) in the coming year compared to the number of units granted (per eligible employee) in the base year. (If eligibility rules are changed, the limitation is applied to the number of units granted per employee in the relevant employee unit.)

6. Exemptions and Exceptions

In the interest of equity and economic efficiency, a number of exceptions and exclusions have been included in the pay standard.

A. Low-wage workers.—Because the poor are least able to bear the burden of fighting inflation, an explicit exemption for low-wage workers is provided. This exemption is effected by requiring that, in the calculation of pay-rate changes, employees earning no more than $4.00 per hour in straight-time wages at the beginning of the program year be excluded from all employee groups. As a result of this exclusion, if pay rates for these low-wage workers increase by more than 7 percent—for example, due to the revision in the minimum wage and the so-called "ripple effect" to avoid compression of the wage structure near the minimum wage—this does not count against the allowable increases for other employees. Also, if pay rates for low-wage workers increase by less than 7 percent, these lesser increases cannot be used to offset greater increases for other workers.

B. Tandem relationships.—An exception to the pay standard is provided for reasons of equity to allow for the continuation of established tandem relationships among employee groups. For example, in some bargaining situations, one or more units traditionally adopt the settlement of a leader unit. Also, some companies have traditionally maintained a fixed differential (or even equality) between the wages of their union and nonunion employees in the same plant or in different plants. Where such tandem relationships exist, it is possible for the follower employee unit to receive a pay-rate increase of more than 7 percent to keep in step with a complying leader unit without being out of compliance. The exception applies, for example, if the leader (collective bargaining) unit signed a contract before the beginning of the program year and the follower unit signs the same contract during the program year. The tandem exception can also be invoked if a leader collective bargaining unit signs a complying contract during the program year that provides for an 8-percent increase in the first year and a follower, nonunion unit is given the same percentage increase.

It should be emphasized that this exception can be invoked only in those situations in which the leader/follower relationship is clear, in terms of both the amount and the timing of pay-rate increases. For example, industry-wide pattern bargaining, in which a settlement with one company—but not always the same company—sets a pattern that is adopted by other companies does not qualify as a tandem relationship because the leader/follower relationship is not fixed over time. Compliance determinations in such situations can, however, be made for the industry as a whole, using the industry-wide base pay rate.

C. Productivity-enhancing work-rule changes.—To promote economic efficiency, pay-rate increases that are traded for work-rule changes that result in demonstrable improvements in productivity are not counted against the 7-percent standard. This exception applies only to collective bargaining situations in which a company has no alternative means of eliminating past contractual work-rule restrictions other than to buy them out through an additional wage-rate increase. The exception does not apply to wage-rate adjustments for improvements in productivity that are not tied to contractual work-rule changes.

D. Acute labor shortages.—Although the pay standard allows for a substantial amount of flexibility in setting pay rates for particular types of workers, this flexibility may be inadequate to retain or attract workers in occupations that are in severely short supply. An explicit exception is therefor provided for cases of acute labor shortages. To invoke this exception, the acute labor shortage must be documented by evidence on the number of vacancies, the time required to fill vacancies, and movements in entry-level pay rates.

E. Undue hardship and gross inequity.—The pay standard, including the above exceptions and exemptions, has been designed to prevent complying workers and businesses from suffering extreme hardship or inequities. Nevertheless, not all situations causing hardship or inequity can be anticipated. For this reason, the standard allows for a general exception for undue hardship and gross inequities. It must be emphasized, however, that to qualify for this exception, a situation must be manifestly unfair. In particular, perceived notions of the need to "catch up" with other groups of workers (even with traditional "comparability groups") do not, in and of themselves, constitute grounds for an exception.

Appendix B. Numerical Example to Illustrate Possible Changes in the Petroleum-Refined Standard

Under the current mix adjustment, the *base-period* gross margin is calculated using program-period quantities. Using the alternative mix adjustment, one would calculate the *program-period* gross margin using base-period quantities. The following example illustrates the difference between the two procedures for changes in product and input mixes that might occur as the result of investments in upgraded refinery processing facilities. On the product side, the mix shifts away from residual oil toward lighter products; on the input side, the mix shifts away from light crude toward heavy crude. The base-year and program-year prices in the example correspond closely to actual average prices during these periods. In the example, the adjustment—and hence the allowable growth in gross margin after the adjustment is made—is much larger using the alternative method. This difference reflects primarily the rapid growth in the price differentials between the base year and the program year.

Tables B–I and B–II show the calculations for the alternative method, while Tables B–III and B–IV refer to the current method. In the former case, the base-year gross margin is $3.50 per barrel, the actual program-year gross margin in $5.77 per barrel, and the constructed program-year gross margin is $3.87 per barrel; hence, the adjustment permits refiners to earn an additional $1.90 per barrel. By comparison, under the current procedure the constructed base-period gross margin is $4.23 per barrel while the actual gross margins in the base period and program year remain the same; hence, the adjustment permits refiners to earn and additional $.83 per barrel, the difference between the constructed and actual base-period gross margins multiplied by 1.135 (the permitted growth in the gross margin over the first two program years).

Table B-I.—*Input-Output Mix Adjustment Example Alternative Method*

Product sales mix	Base year			Program year			Constructed program year		
	Price per barrel (dollars)	Unit sales (K barrels)	Dollar sales (K barrels)	Price per barrel (dollars)	Unit sales (K barrels)	Dollar sales (K barrels)	Price per barrel (dollars)	Unit sales (K barrels)	Dollar sales (K barrels)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Gasoline:									
Regular leaded	$17.50	1,700	$29,750	$32.00	1,500	$48,000	$32.00	1,700	$54,400
Unleaded	19.30	900	17,370	33.60	1,300	43,680	33.60	900	30,240
Premium leaded	20.00	500	10,000	34.40	400	13,760	34.40	500	17,200
Distillates	16.00	2,000	32,000	29.00	2,500	72,500	29.00	2,000	58,000
Residual	12.00	1,130	13,560	22.00	800	17,600	22.00	1,130	24,860
Other	20.00	500	10,000	35.00	600	21,000	35.00	500	17,500
Output mix subtotal	16.74	6,730	112,680	30.50	7,100	216,540	30.04	6,730	202,200

Hydrocarbon cost mix	Base year			Program year			Constructed program year		
	Cost per barrel (dollars)	Quantity (K barrels)	Cost (K dollars)	Cost per barrel (dollars)	Quantity (K barrels)	Cost (K dollars)	Cost per barrel (dollars)	Quantity (K barrels)	Cost (K dollars)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Crude petroleum:									
Light	$12.50	5,000	$62,500	$25.00	3,500	$87,500	$25.00	5,000	$125,000
Heavy	11.00	1,000	11,000	20.00	3,000	60,000	20.00	1,000	20,000
Refined products	15.00	1,000	15,000	30.00	900	27,000	30.00	1,000	30,000
Other hydrocarbons	12.00	50	600	22.00	50	1,100	22.00	50	1,100
Total		7,050	89,100		7,450	175,600		7,050	176,100
Input mix subtotal	13.24	[1]6,730	89,100	24.73	[1]7,100	175,600	26.17	[1]6,730	176,100
Gross margin per sales barrel									
Actual	3.50			5.77			3.87		
Allowable							[2]3.97		

[1] Sales barrels used in computing unit cost.
[2] Equals the actual base-year unit gross margin multiplied by 1.135.

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TABLE B-II

Value of Mix Adjustment - Alternative Method

Product Mix

Actual program-period unit revenues

$$= \sum_j p_j(t)\, q_j(t) \;/\; \sum_j q_j(t)$$

$$= \$30.50.$$

Constructed program-period unit revenues

$$= \sum_j p_j(t)\, q_j(o) \;/\; \sum_j q_j(o)$$

$$= \$30.04.$$

Value of product-mix adjustment = (actual unit revenues - constructed unit revenues) x sales volume

= ($30.50 - $30.04) x 7,100,000 = $3,266,000.

Input Mix

Actual program-period unit cost

$$= \sum_i c_i(t)\, v_i(t) \;/\; \sum_j q_j(t)$$

$$= \$24.73.$$

Constructed program-period unit cost

$$= \sum_i c_i(t)\, v_i(o) \;/\; \sum_j q_j(o)$$

$$= \$26.17.$$

Value of input-mix adjustment = (actual unit cost - constructed unit cost) x sales volume

= ($24.73 - $26.17) x 7,100,000 = -$10,224,000.

Effect on Gross Margin (Additional Allowable Gross Margin)

Effect on gross margin = value of product-mix adjustment - value of input-mix adjustment

= $3,266,000 + $10,224,000 = $13,490,000.

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Table B-III.—*Input-Output Mix Adjustment Example Current Method*

Product sales mix	Base year			Program year			Constructed base year		
	Price per barrel (dollars)	Unit sales (K barrels)	Dollar sales (K barrels)	Price per barrel (dollars)	Unit sales (K barrels)	Dollar sales (K barrels)	Price per barrel (dollars)	Unit sales (K barrels)	Dollar sales (K barrels)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Gasoline:									
Regular leaded	$17.50	1,700	$29,750	$32.00	1,500	$48,000	$17.50	1,500	$26,250
Unleaded	19.30	900	17,370	33.60	1,300	43,680	19.30	1,300	25,090
Premium leaded	20.00	500	10,000	34.40	400	13,760	20.00	400	8,000
Distillates	16.00	2,000	32,000	29.00	2,500	72,500	16.00	2,500	40,000
Residual	12.00	1,130	13,560	22.00	800	17,600	12.00	800	9,600
Other	20.00	500	10,000	35.00	600	21,000	20.00	600	12,000
Output Mix Subtotal	16.74	6,730	112,680	30.50	7,100	216,540	17.03	7,100	120,940

Hydrocarbon cost mix	Base year			Program year			Constructed base year		
	Cost per barrel (dollars)	Quantity (K barrels)	Cost (K barrels)	Cost per barrel (dollars)	Quantity (K barrels)	Cost (K barrels)	Cost per barrel (dollars)	Quantity (K barrels)	Cost (K dollars)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Crude petroleum:									
Light	$12.50	5,000	$62,500	$25.00	3,500	$87,500	$12.50	3,500	$43,750
Heavy	11.00	1,000	11,000	20.00	3,000	60,000	11.00	3,000	33,000
Refined products	15.00	1,000	15,000	30.00	900	27,000	15.00	900	13,500
Other hydrocarbons	12.00	50	600	22.00	50	1,100	12.00	50	600
Total		7,050	89,100		7,450	175,600		7,450	90,850
Input mix subtotal	13.24	[1]6,730	89,100	24.73	[1]7,100	175,600	12.80	[2]7,100	90,850
Gross margin									
Actual gross margin	3.50			5.77			4.23		
Allowable gross margin				[2]4.80					

[1] Sales barrels used in computing unit cost.
[2] Equals the constructed base-year unit gross margin multiplied by 1.135.

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TABLE B-IV

Value of Mix Adjustment - Current Method

Product Mix

Actual base-period unit revenues

$$= \sum_j p_j(o)\, q_j(o) \;/\; \sum_j q_j(o)$$

$$= \$16.74.$$

Constructed base-period unit revenues

$$= \sum_j p_j(o)\, q_j(t) \;/\; \sum_j q_j(t).$$

$$= \$17.03.$$

Value of product-mix adjustments = (constructed unit revenues - actual unit revenues) x 1.135 x sales volume

= $17.03 - $16.74) x 1.135 x 7,100,000 = $2,336,965.

(note: program-period sales volume used in measuring program-period period value of mix adjustment on unit revenues)

Input Mix

Actual base-period unit cost

$$= \sum_i c_i(o)\, v_i(o) \;/\; \sum_j q_j(o)$$

$$= \$13.24.$$

Constructed base-period unit cost

$$= \sum_i c_i(o)\, v_i(t) \;/\; \sum_j q_j(t)$$

$$= \$12.80.$$

Value of input-mix adjustment = (constructed unit cost - actual unit cost) x 1.135 x 7,100,000

= ($12.80 - $13.24) x 1.135 x 7,100,000 = -$3,545,740.

(note: program-period sales volume used in computing program-period value of mix adjustment on unit cost)

Effect on Gross Margin (Additional Allowable Gross Margin)

Effect on gross margin = value of product-mix adjustment - value of input-mix adjustment

= $2,336,965 + $3,545,740 = $5,882,705.

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